Article:
Parada, L (2019) Hybrid Entity Mismatches: Exploring Three Alternatives for Coordination. Intertax, 47 (1). pp. 24-54. ISSN 0165-2826

ARTICLE

Hybrid Entity Mismatches: Exploring Three Alternatives for Coordination

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The OECD pragmatic approach regarding hybrid entity mismatches is, without doubt, questionable. However, equally questionable is the absence of alternatives solutions proposed by either academics or tax policy makers , which demonstrates a sort of conformism as regards both the diagnosis of the problems and the solutions thereto, as if matching tax outcomes and taxing income somewhere – no matter where – were indeed the only possible path to deal with hybrid entity mismatches.

In an attempt to break this inertia, this article argues for coordination in the tax characterization of entities as a straightforward and suitable alternative to replace the current OECD linking rules, and perhaps also, the consequentialist OECD approach to hybrid entity mismatches. For this purpose, three specific alternatives are explored for coordination in the tax characterization of entities, which include (1) supremacy of the tax characterization rules of the source state, (2) supremacy of the tax characterization rules of the residence state and (3) supremacy of the tax characterization rules of the home state. The analysis of these alternatives includes both hypotheticals and specific examples from domestic and supranational laws that are used to illustrate and support their effectiveness. The ultimate aim of this article is to demonstrate that coordination in the tax characterization of entities appears to be not only a more preferable path when compared to the OECD approach of matching tax outcomes, but also a more coherent and less costly alternative for both taxpayers and tax administrations.

1 Introduction

The OECD pragmatic approach regarding hybrid entity mismatches is, without doubt, questionable.[1] Indeed, since the OECD Base Erosion and Profit Splitting (BEPS) Action 2 Final Report was issued,[2] the approach of matching hybrid entity transactions and double non-taxation has gained ground, even though no certainty exists as to whether these two elements are necessarily interconnected or as to whether they should serve each other in the design of domestic anti-hybrid entity provisions.[3] Nevertheless, equally questionable is the lack of serious alternative solutions proposed by either academics or tax policy makers,[4] which demonstrates a sort of conformism as regards both the diagnosis of the problems and the existing solutions thereto, as if matching tax outcomes and taxing income somewhere – no matter where – were indeed the only possible path.[5]

In an attempt to break this inertia, this article argues for coordination in the tax characterization of entities as a more

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1 For a recent critical review of the OECD approach to hybrid entity mismatches and the OECD linking rules, *see* L. Parada, *Hybrid Entity Mismatches and the International Trend of Matching Tax Outcomes: A Critical Approach*, 46 Intertax 12 (2018). For a critical perspective, *see also* e.g. G. Cooper, *Some Thoughts on the OECD's Recommendations on Hybrid Mismatches*, 69(6/7) Bull. Int'l Tax'n (2015); J. Lüdicke, *'Tax Arbitrage' with Hybrid Entities: Challenges and Responses*, 68(6/7) Bull. Int'l Tax'n (2014).

2 OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 5 Oct. 2015). *See also* OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing 2013). For an early analysis of the OECD BEPS Report, *see* Y. Brauner, *BEPS: An Interim Evaluation*, 6(1) World Tax J. (2014).

3 For a specific analysis of the interaction between double non-taxation and the use and misuse of hybrid and reverse hybrid entities, *see* L. Parada, *Double Non-Taxation and the Use of Hybrid Entities: An Alternative Approach in the New Era of BEPS,* (Kluwer Law International 2018). For a very notable and complete analysis of double non-taxation in the European Union, *see* C. Marchgraber, *Double Non-Taxation and EU Law*, Eucotax Series vol. 57 (Kluwer Law International, 2017).

4 However, there are exceptions to coordination and harmonization regarding the tax characterization of entities. E.g. Fibbe has proposed (specifically in the context of the European Union) a uniform classification method in the EU by mutually recognizing the tax classification of an entity in its host country. This method is based on the principle of mutual recognition of entities reinforced by the Court of Justice of the European Union (ECJ)'s holding in *Columbus Container Services.* Fibbe's proposal would be materialized in an EU Directive. For the detailed proposal, *see* G. Fibbe, *EC Law Aspects of Hybrid Entities*, vol. 15, Doctoral Series, 293–384 (IBFD 2009). *See also* DE: ECJ, 6 Dec. 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt*, ECLI:EU:C:2007:754. For a proposal more along the line of coordination, *see* Parada, *supra* n. 3, at 353–398. This proposal for coordination is analysed later in this article. *See* s. 3.3. For an analysis of this proposal and its implications under tax treaties, *see* L. Parada, *Hybrid Entities and Conflicts of Allocation of Income Within Tax Treaties: Is the New Article 1(2) OECD Model {Article 3(1) MLI} the Best Solution Available?*, 3 Brit. Tax Rev. 335–340, 335–376 (2018).

5 For the debate on single taxation, *see* R. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* 8–13 (Cambridge University Press 2007). *See also* R. Avi-Yonah, *International Taxation of Electronic Commerce*, 52(3) Tax L. Rev. 507 (1997). Supporting this idea, e.g. H. Ault, *The Importance of International Cooperation in Forging Tax Policy*, 26 Brook. J. Int'l L. 1, 1693 (2001); H. Ault, *Some Reflections on the OECD and the Sources of International Tax Principles*, 70(12) Tax Notes

straightforward and suitable alternative to replace the current OECD linking rules, and perhaps also, the consequentialist OECD approach to hybrid entity mismatches. For this purpose, three alternatives are explored for coordination in the tax characterization of entities. The analysis ultimately aims at demonstrating that coordination appears to be not only a more preferable path when compared to the OECD approach of matching tax outcomes, but also a more coherent and less costly solution for both taxpayers and tax administrations.

Section 2 delimits the scope of this article. Section 3 analyses three alternatives for coordination in the tax characterization of entities, which include (1) supremacy of the tax characterization rules of the source state, (2) supremacy of the tax characterization rules of the residence state and (3) supremacy of the tax characterization rules of the home state. Each of these proposals is briefly described, and hypotheticals are provided as regards both hybrid and reverse hybrid entity structures. Additionally, similar examples of coordination taken from domestic and supranational laws – especially from EU tax law – are provided in order to support the author's assertions.

Section 4 is divided into two parts. The first part refers to the implementation of these proposals. In particular, it stresses that only a uniform and worldwide implementation of a coordination rule – granting supremacy to the tax characterization in either the source state, the residence state or the home state – could ensure a true success. Accordingly, it reinforces the idea that only one of these proposals could be implemented worldwide in order to ensure that complexity and transaction costs are truly reduced under the proposed scenarios. The second part turns the analysis to specific open questions as regards the three proposals analysed here. This reinforces the idea that none of the proposals pretend to be perfect solutions, let alone unbeatable ones, but rather serve the humble purpose of reorientating the debate on hybrid entity mismatches to what really matters.

2 Scope and hypotheses

This article aims to provide three specific alternatives for coordination in the tax characterization of entities, which should serve as a straightforward and suitable alternative to replace the current OECD *linking rules.* The alternative proposals are presented in a neutral manner, i.e. without necessarily disclosing the preferences of the author for one or the other. Accordingly, these proposals are mutually exclusive. Therefore, only one of them should uniformly be implemented worldwide.[6] In other words, they do not seek to be presented as different available alternatives from amongst which countries should follow the most suitable option for them. That would only increase the level of complexity and transaction costs to levels equal to – or exceeding – those under the OECD linking rules.[7]

This article provides some specific alternatives only as regards hybrid entity mismatches. Therefore, the analysis excludes all cases involving hybrid financial instruments, i.e. cases when two countries classify the same financial instrument differently: as debt in one jurisdiction and as equity in the other.[8] Likewise, this article does not include cases of hybrid permanent establishment (PE) mismatches, i.e. when two jurisdictions disagree as to whether a business activity is being carried out through a PE or not, nor does it refer to the implications of the proposed rules within tax treaties. The analysis of the proposals themselves is carried out using hypotheticals that include both hybrid entities and reverse hybrid entities, both receiving and making deductible payments. A particular focus is on cases where a deduction/non-inclusion comes into play. However, other situations are also contemplated. Yet, consideration of some issues considered under OECD BEPS Action 2, such as double deduction outcomes or dual resident mismatches, is beyond the scope of this article.

Finally, unless indicated otherwise, all the hypotheticals presented in this article assume that no withholding tax is applied at source and that the domestic tests of domestic general anti-avoidance rules (GAARs) have been successfully passed.

The elaboration of the alternatives and their subsequent analysis is based on the following three hypotheses:

(1) The *consequentialist approach* adopted by the OECD as regards hybrid entity mismatches has resulted in a complex set of rules – OECD linking rules – the efficacy of which is rather questionable.[9] For this reason, double non-taxation – or deduction/non-inclusion

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Intl. 1195 (2013); Y. Brauner, *An International Tax Regime in Crystallization*, 56 Tax L. Rev. 259 (2003); Y. Brauner, *Integration in an Integrated World*, 2(1) N.Y.U. J. L. & Bus. 51 (2005); L. Dell'Anese, *Tax Arbitrage and the Changing Structure of International Tax Law* (Egea 2006). More recently, *see* R. Avi-Yonah, *Who Invented the Single Tax Principle?: An Essay on the History of U.S. Treaty Policy*, 59 N.Y.L. Sch. L. Rev. 305, 309 (2014–2015); R. Avi-Yonah, *The International Tax Regime: A Centennial Reconsideration*, U. of Mich. Public Law Research Paper No. 462 (2015). In contrast, e.g. H. D. Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the 'International Tax System'*, 53 Tax L. Rev. 137 (2000); H. D. Rosenbloom, *Cross-Border Arbitrage: The Good, The Bad and the Ugly*, 85 Taxes (2007); J. Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 Geo. L. J. 543 (2000); M. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53(1) Emory L. J. 89 (2004); M. J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 26(4) Brook. J. Int'l L. 1357 (2001); D. Shaviro, *The Two Faces of the Single Tax Principle*, N.Y.U. Law and Economics Working Papers, Paper No. 419, 1 (2015).

6 For a full analysis, *see* s. 4.

7 The complex construction and high transaction costs associated with the OECD linking rules have been largely discussed by this author. Parada, *supra* n. 1.

8 For a complete study of this specific topic, *see* e.g. J. Bundgaard, *Hybrid Financial Instruments in International Tax Law* (Wolters Kluwer 2017).

9 This author has already provided arguments elsewhere in this regard. Parada, *supra* n. 1.

outcomes – should be completely disregarded in the design of hybrid entity mismatch rules.[10]

(2) As the reason for the existence of hybrids and reverse hybrid entities is indeed the different tax characterization of entities, attention should be turned back to this fundamental element rather than sticking to the outcomes of the specific transaction. In this sense, rules aligning the tax characterization of entities (or coordination rules) appear to be more appropriate to achieve this aim.

(3) Even though single taxation is not the core of the proposed alternatives in this article, they prove to be very effective in achieving such a result. Therefore, those in favour of a more consequentialist approach as regards hybrid entity mismatches should also see these alternatives as desirable.

3 Analysis: three alternatives for coordination

This section explores three possible scenarios for the coordination of the tax characterization of entities as a suitable alternative to replace the current OECD linking rules and perhaps also, the consequentialist approach adopted by the OECD on this matter. The analysis of these alternatives aims to demonstrate that coordination appears to be not only a more preferable path when compared to the OECD approach of matching tax outcomes, but also a more coherent and less costly solution for both taxpayers and tax administrations.

This section analyses three specific scenarios for coordination, namely (1) supremacy of the tax characterization rules of the source state, (2) supremacy of the tax characterization rules of the residence state and (3) supremacy of the tax characterization rules of the home state.

3.1 *Supremacy of the Tax Characterization Rules of the Source State*

3.1.1 *The Proposal*

The first alternative is to coordinate the tax characterization of the entity the tax characterization of which is relevant (i.e. when a relevant payment exists) based on that given to it in the source state, i.e. the state of the entity making the relevant payments. In other words, if two or more jurisdictions differ as regards the tax characterization of the same entity giving rise to hybrid or reverse hybrid entities and a relevant payment exists, the residence state of the investors (and the residence state of the relevant entity, as well) must follow the tax characterization given to the entity in the state from which the relevant payments are made, i.e. the source state.

This rule could be introduced as a domestic rule using the following wording: 'Where according to the rules of a State, a different tax characterization is given to the same entity, the tax characterization given to that entity by the State where the relevant payment has its source, shall be followed by the other(s) State (s)'. The implications of such a coordination rule at source will depend on whether one refers to cases involving hybrid or reverse hybrid entities and on whether one refers to relevant payments made from or received by these entities. All of these situations are analysed below.

3.1.2 *Illustrations*

3.1.2.1 Cases Involving Hybrid Entities

A rule granting supremacy to the tax characterization rules in the source state might work very well in a context where a hybrid entity makes a deductible payment to a related entity in another state where that payment is disregarded due to the tax transparency of the payer entity.

Assume that ACo, a taxable entity incorporated in State *A*, grants a loan to BSub, an entity organized in State *B*. BSub pays interest in the amount of 100 connected to that loan.[11] Also assume that State *B* does not apply a withholding tax at source. Accordingly, while State *A* regards BSub as tax transparent, State *B* regards the same entity as a taxable or opaque entity. In other words, BSub will be considered a hybrid entity making a deductible payment of interest, which – due to the tax transparency of BSub in State *A* – will not be recognized as ordinary income in State *A* either.

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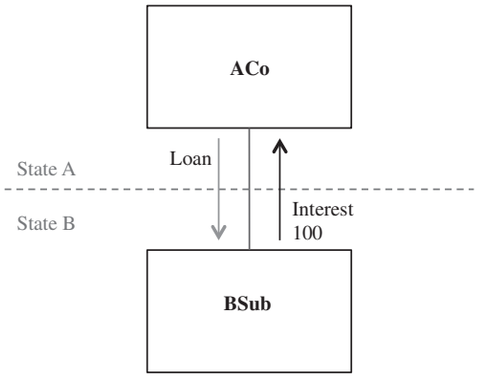
[10] Double non-taxation is an ambiguous concept the proper understanding of which is generally underestimated. For an analysis of the different attempts to explain this concept, *see* Parada, *supra* n. 3, at 13–22. According to this author: 'The boundaries of the notion of DNT should remain within its nature of a simple outcome, absent of subjective interpretations, not being thus regarded per se a cause of concern'. Parada, *supra* n. 3, at 50–51. Similarly, Marchgraber explains: '[…]not all situations where something remains untaxed are necessarily problematic[…] But even with regard to those scenarios of alleged double non-taxation that are considered to be problematic from a tax policy perspective, referring to the phenomenon of double non-taxation is not in itself sufficient to prove that there is a legal problem […] Hence, the term double non-taxation seems to be legally inexistent'. Marchgraber, *supra* n. 3, at 13.

[11] The example also assumes that the loan is made at arm's length and that resulting interest is calculated and charged accordingly.

Figure 1 Coordination in the Source State and Deductible Payments from Hybrid Entities

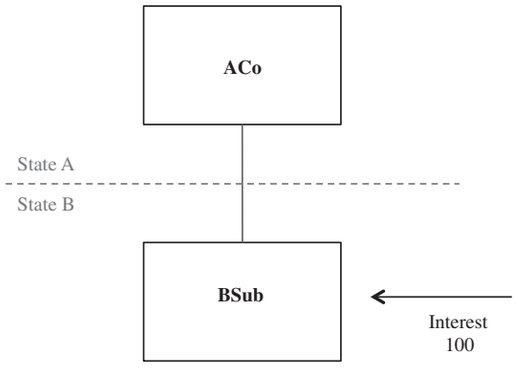


State A and State B will consider BSub as a taxable entity. Thus, there will be no mismatch either as regards the tax characterization of the entity or as regards the interest payment.

In this case, a rule granting supremacy to the tax characterization of BSub in State *B* (the source state) will mean that State *A* will follow the tax characterization of BSub in State *B*. In other words, BSub will also be regarded as a taxable entity in State *A*. Therefore, a mismatch will no longer arise as regards the tax characterization of BSub. Accordingly, there will be no disparity as regards the payment either, because BSub will be recognized as a taxable entity in the two states involved in the transaction (State *A* and State *B*). That is, even though the payments of interest in this hypothetical will still be deductible in State *B*, they will be recognized as ordinary income in State *A*. This result should therefore also satisfy those in favour of a more consequentialist approach to hybrid entity mismatches.[12]

Similarly, a coordinated solution granting supremacy to the tax characterization rules in the source state appears to be very effective in cases where a hybrid entity is receiving a deductible payment from either a third (source) state or a taxpayer located in a state different from the payee entity and which controls it. Scenario 1 (i.e. a deductible payment made from a party in a third country) can be illustrated using the same example of Figure 1, with the only difference that BSub receives interest payments.

Figure 2 Coordination in the Source State and Deductible Payments Made to Hybrid Entities (Scenario 1)



State A and State B will consider BSub as a taxable entity. However, none of these two States is the source state.

If BSub is characterized for tax purposes according to the tax characterization given in the source state, it is evident that the source state will be neither State *B* nor State *A*, but rather a third state from which the relevant payment is made. The tax treatment of BSub will therefore depend exclusively on this third state. Thus, if, on the one hand, the third state treats BSub as a tax transparent entity, the interest payments will be recognized as ordinary income in State *A*.[13] If, on the other hand, the third state treats BSub as a taxable entity, interest will be allocated to BSub in State *B*. In this latter case, however, nothing prevents State *A* from applying its controlled foreign company (CFC) legislation, which could give rise to a potential case of double taxation. This outcome, although undesirable, is perfectly avoidable in practice.[14]

Still, the author recognizes that relying exclusively on the tax characterization given in a third (source) state might give rise to abusive practices, as a third state might be chosen just for purposes of arriving at an expected result in a transaction involving two other states where a hybrid entity receives a payment.[15]

Notes

[12] For an analysis of the OECD consequentialist approach, *see* Parada, *supra* n. 1.

[13] This should also satisfy the expectations of those arguing for matching tax outcomes, because the deductible payments will be recognized as income somewhere, even though effective taxation does not ultimately exist. Indeed, effective single taxation will depend on the total amount of income and expenses at the level of ACo in State *A* in this case.

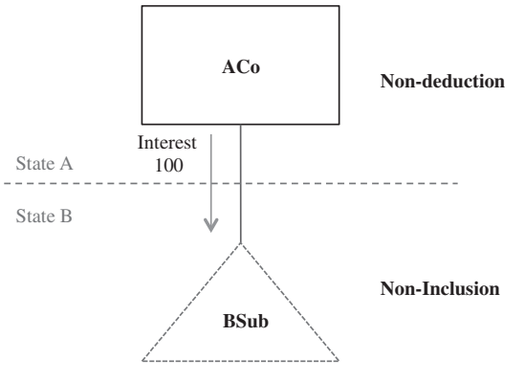
[14] E.g. in the United States, s. 960 of the Internal Revenue Code (IRC) provides for a foreign tax credit with respect to the taxes paid at the level of the foreign-controlled entity. If corporations claim the credit, the applicable provision is IRC Sec. 902. Likewise, the deemed foreign tax credit under s. 960 is available for taxes paid by subsidiaries through the sixth tier. *See* US: IRC ss 960 & 902.

[15] E.g. tax transparency in the source state might help BSub to avoid taxation in State *B*, knowing also that no taxation (or minimal taxation) will occur in State *A*. This is not *a priori* an abusive practice, but it could be questionable if the transaction was crafted based exclusively on arriving at this tax outcome, especially considering the application of GAARs.

Considering the above, countries could still have the chance not to apply the proposed coordination rule to these specific situations. The forgoing should not vary the position of those supporting the OECD approach to hybrid entity mismatches, because indeed these cases of hybrid entities receiving payments were not originally considered in the scope of the OECD linking rules either.[16]

Scenario 2, i.e. a deductible payment received from a company controlling the hybrid entity and which is located in a different state, can be illustrated using the same example as that used in Figure 1, with the only difference than ACo makes a deductible payment to BSub.

Figure 3 Coordination in the Source State and Deductible Payments Made to Hybrid Entities (Scenario 2)



In this case a coordinated solution that grants supremacy to the tax characterization rules in the source state will mean that BSub is regarded as a tax transparent entity in State *A* and State *B*. This is due to the tax treatment in the source state (State *A*), where BSub is seen as fiscally transparent. Therefore, the loan transaction (including the interest payments) will be disregarded for tax purposes in both State *A* and State *B*, which will give rise to a non-deduction/non-inclusion outcome. This outcome could raise the alarm amongst some in the international tax community. However, the use of double non-taxation as the core element to design anti-hybrid entity rules is very questionable and it is certainly out of the concern of the proposed coordination rule.[17] Furthermore, in the author's opinion, in these cases where double non-taxation arises in the form of a 'non-deduction/non-inclusion', it should be simply disregarded or assumed as a sunk cost of the elimination the true hybrid entity mismatch, i.e. the different tax characterization of the same entity by two jurisdictions.[18] Yet, if countries still conclude that non-taxation will jeopardize their interests, they might have the option to make the rule not applicable to these specific cases.[19]

3.1.2.2 Cases Involving Reverse Hybrid Entities

A coordinated solution granting supremacy to the tax characterization rules in the source state will also have a positive impact in cases involving payments made to a reverse hybrid entity.

In the example below, BSub is a reverse hybrid entity, i.e. under the tax law of State *B*, BSub is regarded as a transparent entity while State *A* and State *C* regards BSub as a taxable or opaque entity. Accordingly, assume that BSub receives interest from CSub1, a sub-subsidiary that is established in State *C*. If a coordinated solution granting supremacy to the tax characterization rules in the source state is applied, State *B* (payee state) and State *A* (investors state) will follow the tax characterization of BSub given in State *C*, i.e. where the relevant payment has its source.[20] In this case, State *C* treats BSub as a taxable entity. Thus, the three states involved in this hypothetical will regard BSub as a taxable entity. In other words, a coordinated solution granting supremacy to the tax characterization rules in the source state will completely eliminate the hybrid entity mismatch.[21] Yet, potential double taxation issues might still arise, particularly if State *A* decides to apply its CFC rules. This outcome is nonetheless avoidable if domestic relief is granted, which appears to be a generalized practice.[22]

Notes

[16] OECD, *Action 2: 2015 Final Report, supra* n. 2, at 49.

[17] *See* s. 2.

[18] Indeed, if countries were truly concerned about the non-taxation outcome, they could simply opt not to make the coordination rule applicable to cases involving a payment made to a hybrid entity. Yet, the tax outcome should not be the starting point of the discussion, but rather the elimination of the disparity in the tax characterization of the same entity. *See also* the hypotheses of this article at s. 2. For a more developed argument as regards the relationship between double non-taxation and hybrid entity rules, *see* Parada, *supra* n. 3.

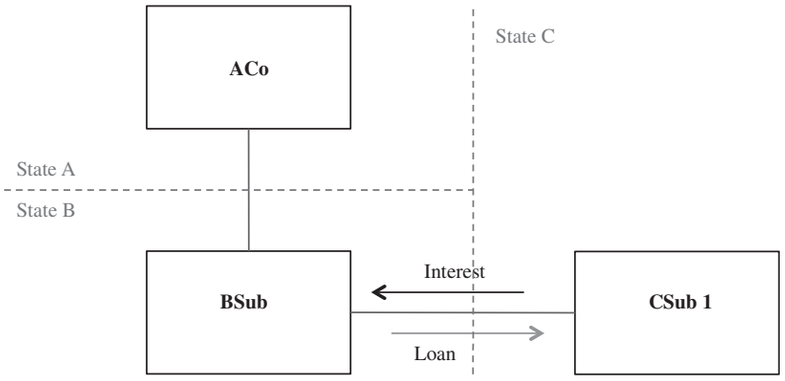
[19] These situations of hybrid entities receiving a payment were also not included in the OECD BEPS Action 2 Final Report, as they did not generate a deduction/non-inclusion outcome. OECD, *Action 2: 2015 Final Report, supra* n. 2, at 49.

[20] The determination of source might nonetheless be troublesome. For a further analysis, *see* s. 4.2.1.

[21] Even if State *A* were to change its tax characterization of BSub as a fiscally transparent entity, the solution should be satisfactory from a single taxation perspective, because the interest payments would be recognized as ordinary income in State *A* anyway. Nonetheless, *see also* the concerns raised by this author with respect to achieving 'effective single taxation' at *supra* n. 13.

[22] *Supra* n. 14.

Figure 4 Coordination in the Source State and Deductible Payments Received by a Reverse Hybrid Entity



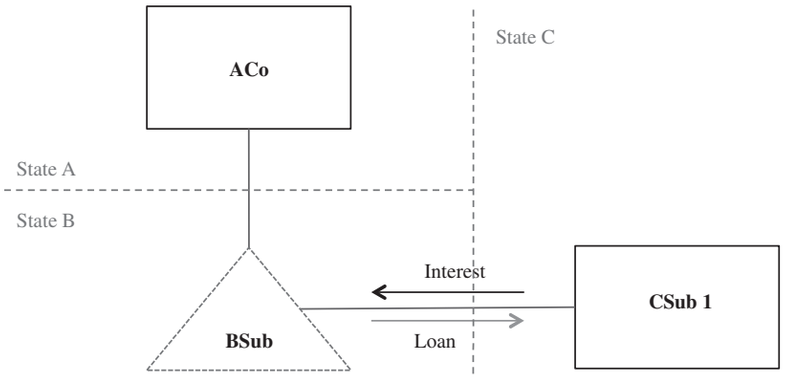
If coordination in the source state applies, BSsub will be regarded as a taxable entity in State A, State B and State C. The hybrid entity mismatch is solved, although potential double taxation issues might arise if State A applies its CFC legislation.

Accordingly, if BSub is now regarded as a tax transparent entity in State *C* (the source state), the outcome of granting supremacy to the tax characterization rules in the source state is still desirable. First, the hybrid entity mismatch disappears, as States *A*, *B* and *C* will regard BSub as a tax transparent entity. Second, there will be no need to rely on CFC rules in order to ensure that the interest payments are recognized as ordinary income somewhere, because ACo will recognize those interest payments as income in State *A* due to the tax transparency treatment of BSub. This outcome should therefore also satisfy those who argue for ensuring single taxation in cases involving hybrids.

Nevertheless, the downside of granting supremacy to the tax characterization rules in the source state in this case is that the source state will never coincide with the state in which the entity is formally or legally established. That is to say, a provision granting supremacy to the tax characterization rules in the source state will always mean that the tax characterization of BSub in a third country (State *C*) prevails, which could raise questions as regards both legal certainty and excessive reliance on foreign law.[23]

From a different perspective, a rule granting supremacy to the tax characterization rules in the source state might be more questionable in the case of deductible payments made from a reverse hybrid to a third state different from

Figure 5 Coordination in the Source State and Deductible Payments Received by a Reverse Hybrid (Option 2)

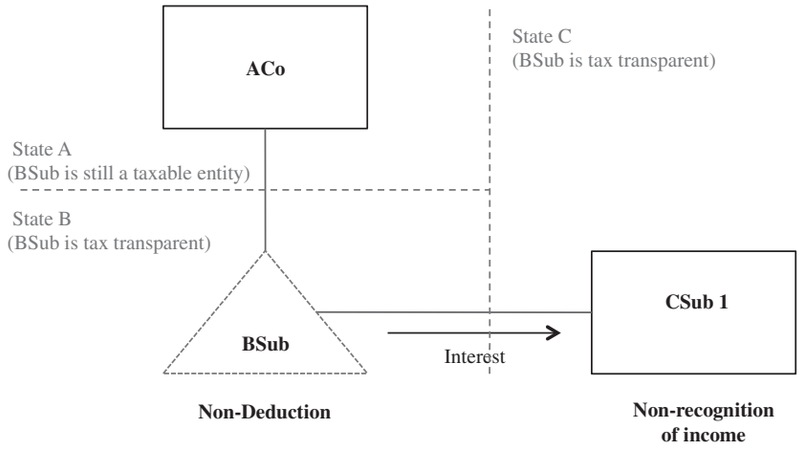


If coordination in the source states applies, BSsub will be regarded as a tax transparent entity in States A, B and C. The hybrid entity mismatch is solved. Accordingly, there will be no need to rely on CFC legislation in order to ensure that the interest payments are included as ordinary income in State A.

Notes

[23] For further analysis, *see* s. 4.2.1.

Figure 6 Coordination in the Source State and Deductible Payments Made by a Reverse Hybrid Entity to a Third State

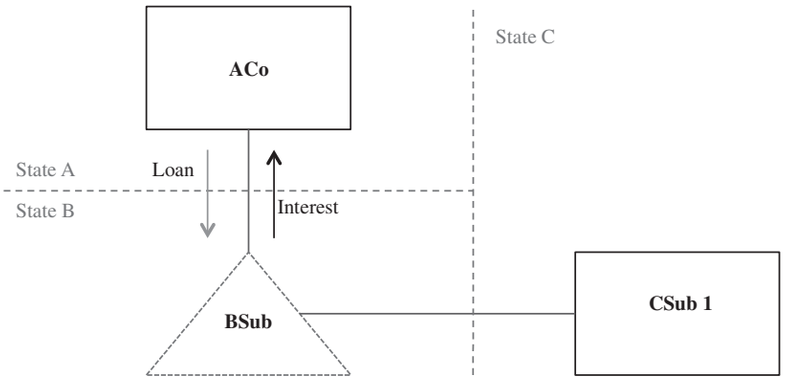


the state of the investors controlling the reverse hybrid entity. This can be illustrated using the facts in Figure 4, with the sole difference that a payment of interest is made from BSub to CSub1 (*see* below).

Based on the facts of this hypothetical, BSub will be regarded as a tax transparent entity in State *A* (investors state), State *B* (the source state) and State *C* (the payee state). The outcome of this transaction ('deduction/non-inclusion') might nonetheless generate some concern amongst some in the international tax community. However, in the author's opinion, this concern would not be unjustified, as design of the coordination rule does not pay attention to the occurrence (or not) of double non-taxation.[24] In spite of the foregoing, nothing would prevent countries from opting not to apply the proposed coordination rule in those specific cases where a reverse hybrid is making a payment to a third country. After all, those cases were originally excluded from OECD BEPS Action 2 because they did not generate a double non-taxation concern.[25] In other words, if some countries still conclude that non-taxation jeopardizes their domestic position, the option to step out could be available.

Finally, in cases of reverse hybrid entities making deductible payments to the state where the investors controlling the entity are located, the outcome of granting supremacy to the tax characterization rules in the source state might also be questionable, especially for those arguing for single taxation. Take the facts of Figure 4, with the only difference that BSub pays interest to ACo.

Figure 7 Coordination in the Source State and Deductible Payments Made by a Reverse Hybrid to Its Controlling Investor



State A and State B will consider BSub as a fiscally transparent entity. The tax treatment in State C in this case is irrelevant, because the payment is sourced in State B and the investors are in State A.

Notes

[24] *See* the hypotheses of this article in s. 2.

[25] OECD, *Action 2: 2015 Final Report, supra* n. 2, at 59–60.

If a rule granting supremacy to the tax characterization in the source state is applied, States *A* and *B* will regard BSub as a fiscally transparent entity, which is the tax treatment given in State *B* (the source state). Therefore, the interest payments will not be deductible in State *B* and they will also not be recognized as income in State *A*, because the whole transaction is disregarded for tax purposes in that state.

As to the tax treatment in State *C*, this is partially irrelevant, as the payment is sourced in State *B* and the investors are located in State *A*. However, if State *C* treats BSub as a tax transparent entity, an interest deduction in State *C* can be generated by the sole application of the proposed coordination rule. This deduction will not be followed by a corresponding recognition of income in State *A* due to the tax transparency of BSub in State *A* and State *B*, as well. Although this deduction/non-inclusion outcome could again be viewed with scepticism by a significant portion of the international tax community, it is important to highlight again that the use of double non-taxation as the core element when designing anti-hybrid rules is highly questionable.[26] Nonetheless, this should not prevent countries from opting not to apply the proposed coordination rule to these specific cases where a reverse hybrid entity is making a payment to its investors.[27]

3.1.3 *Practical Examples in Support of this Proposal*

Some examples of supremacy given to the tax characterization rules in the source state can be found either in the text of the law or as a result of the interpretation of the law or administrative practice. The cases of Article 10 of the Proposal for the EU Anti Tax Avoidance Directive (ATAD) and the Spanish tax characterization rules are briefly referred to below as two examples of this. This section does not provide an in-depth analysis of these specific measures, but rather offers a practical approach to the hypothetical analysis already carried out in section 3.1.2.

3.1.3.1 Article 10(1) of the Proposal for the EU Anti-Tax Avoidance Directive

In 2016 the European Commission issued a proposal for a Council Directive, the purpose of which was to lay down rules against tax avoidance practices that might affect the internal market.[28] In this regard, the following specific rule on hybrid mismatch arrangements was introduced:

> 'Where two Member States give a different legal characterization to the same taxpayer (hybrid entity), including its permanent establishments in one or more Member States, and this leads to either a situation where a deduction of the same payment, expenses or losses occurs both in the Member State in which the payment has its source, the expenses are incurred or the losses are suffered and in another Member State or a situation where there is a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion of the same payment in the other Member State, *the legal characterization 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*' (emphasis added).[29]

As to hybrid entity mismatches, this rule means that if a legal entity organized in an EU Member State, which is treated as a taxable entity there, pays deductible interest to its parent company located in another EU Member State, where the same entity (payer) is regarded as fiscally transparent, the EU Member State of the recipient entity must follow the tax characterization given to the payer entity in the Member State where the interest payments were sourced. In other words, Article 10 of the Proposal for the EU ATAD not only helps to avoid double non-taxation (which is arguably the true reason for hybrid entity mismatches), but also directly solves the disparity in the tax characterization of the relevant entity, which appears to be the core of the issue at stake. The outcome would therefore be exactly as demonstrated in Figure 1

Notes

[26] *See* hypotheses in s. 2. and references at *supra* n. 10. *See also* Parada, *supra* n. 1.

[27] As already emphasized in this article, these situations in which a reverse hybrid entity makes a deductible payment to its controlling company were not considered as a concern in the OECD BEPS Action 2 Final Report, either, because the outcome (deduction/non-inclusion) was not present. OECD, *Action 2: 2015 Final Report, supra* n. 2, at 59–60.

[28] European Commission, *Proposal for a Council Directive lying down rules against tax avoidance practices that directly affect the functioning of the internal market*, COM (2016) 26 final (28 Jan. 2016). This proposal was part of a full Anti-Tax Avoidance Package that included other initiatives, e.g. a recommendation on tax treaties; a revision of the Administrative Cooperation Directive; a Communication on an External Strategy for Effective Taxation and a Chapeau Communication and Staff Working Document. *See* Council of the European Union, *Report of the Code of Conduct Group (Business Taxation)*, 16553/1/1/14 Rev. 1, FISC 225, ECOFIN 1166, (11 Dec. 2014). *See also* European Commission, *Commission Communication, A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action*, COM (2015) 302 final, (17 June 2015). The solution of the original proposal for EU ATAD was also in line with the recommendation of the European Parliament of Dec. 2015, where it called for a proposal 'to either harmonize national definitions of debt, equity, opaque and transparent entities […]; or prevent double non-taxation, in the event of a mismatch'. European Commission, Recommendation C6 'Hybrid Mismatches' of the Resolution of the European Parliament with recommendations to the Commission on bringing transparency, coordination and convergence to corporate tax policies in the Union, 2015/2010 (INL), (16 Dec. 2015). For an early analysis of the different measures included in the EU proposal, *see* A. Navarro, L. Parada & P. Schwarz, *The Proposal for an EU Anti-Avoidance Directive: Some Preliminary Thoughts*, 25 EC Tax Rev. 3 (2016). *See also* S. Krauß, *EU-BEPS? Aktionsplan für eine faire und effiziente Unternehmensbesteuerung in der EU*, Internationales Steuerrecht 2, 45 et seq (2016). For an EU proposal of harmonization as regards the tax characterization of entities rules under the principle of mutual recognition of entities in EU Law, *see* Fibbe, *supra* n. 4, at 293–384.

[29] European Commission, *Proposal for a Council Directive*, *supra* n. 28, Art. 10(1).

above.[30] Accordingly, granting supremacy to the tax characterization rules in the source Member State directly avoids implementing more invasive measures, such as obligating a Member State to deny a deduction when a correspondent inclusion of income is not made in the other Member State, or to force a Member State to recognize a deductible payment as ordinary income, even though such a payment is originally disregarded because of the tax treatment of the entity making the payment.[31] This approach ultimately prevents complexities and consequentialist approaches that might ultimately affect legitimate transactions.[32] Needless to say, such an approach makes total sense in a regional coordinated context such as the European Union.[33]

Beyond the similarities with the proposed coordination rule, Article 10 of the Proposal for the EU ATAD still has deviations that mostly relate to the context and scope of this latter rule. For example Article 10 of the Proposal for the EU ATAD was designed to apply exclusively within the EU context. That is, all the cases of hybrid entity mismatches with third countries fell outside the scope of the rule. This raised significant questions, especially as regards cases involving US owners holding ownership in EU hybrid entities, particularly because of the use of the check-the-box regulations in the United States.[34] Indeed, it is evident that the elective nature of US tax law in determining the tax characterization of a foreign entity places US investors holding ownership in EU entities in a relatively privileged position vis-à-vis EU or even third country investors.[35] This issue was nonetheless partially resolved with the extension of the hybrid rules to cases involving hybrid entity mismatches outside the EU according to the amendments in the EU ATAD 2. However, there are still doubts with respect to certain transactions included within the scope of the EU ATAD 2.[36] Likewise, one should also consider that Article 10 of the Proposal for the EU ATAD did not completely depart from the OECD consequentialist approach. That is, the rule applied only to the extent that a disparate tax characterization as regards the same entity existed and that disparity resulted in a deduction/non-inclusion outcome.[37] This idea is nonetheless overcome in this article. Indeed, no attention is paid to the outcome of the hybrid transaction, but rather – and exclusively – to the disparate tax characterization of the same entity.[38]

3.1.3.2 The Spanish Coordination Practice: Deductible Payments from Hybrid Entities

The Spanish administrative tax practice as regards the tax characterization of foreign entities is another example that supports the notion of granting supremacy to the tax characterization in the source state. However, this is true only in the cases where a foreign hybrid entity makes deductible payments to the Spanish investors controlling the relevant entity.[39] In all other cases involving hybrid entity mismatches, e.g. when Spanish investors controlling the foreign hybrid entity makes deductible payments to it or when a foreign hybrid entity or a reverse foreign hybrid receive deductible payments from a party in a third country in a triangular case, the Spanish interpretation

Notes

[30] The author provides elsewhere a simple example where a company (*X*) organized in Member State 1 has a subsidiary (*Y*) in Member State 2. For Member State 1's tax purposes, *Y* is tax transparent, while for Member State 2's tax purposes, the same entity is regarded as a taxable entity. It is also assumed that *X* grants a loan to *Y* and *Y* pays interest thereon. As noted there, Art. 10 of the Proposal for the EU ATAD means that *Y* (payer) will deduct the interest in Member State 2, but this payment will be recognized as ordinary income in Member State 1. Thus, both the hybrid entity mismatch and the disparity as regards the payment (deduction/non-inclusion outcome) disappear. Parada, *supra* n. 3, at 174, Figure 20.

[31] These were unfortunately the final rules (OECD linking rules) introduced in the EU ATAD 1. *See* EU Anti-Tax Avoidance Directive (ATAD 1): 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, OJ L193/1 (19 July 2016), Art. 9. For a general analysis of the rules, *see* G. K. Fibbe, *Hybrid Mismatch Rules under ATAD I & II*, in *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* (P. Pistone & D. Weber eds, IBFD 2018). *See also* O. Popa, *Recent Measures to Counter Hybrid Mismatch Arrangements at the EU Level*, 57 Eur. Tax'n. 9 (2017).

[32] For a critical view of the OECD consequentialist approach, *see* Parada, *supra* n. 1.

[33] Navarro, Parada & Schwarz, *supra* n. 28, at 129.

[34] Generally speaking, the US check-the-box regulations provide that an 'eligible (foreign) entity' (i.e. an entity not listed as a per se corporation in Treas. Reg. Sec. 301.7701–2(b)(8)) may elect to be classified either as an association, which is taxable as a corporation in the United States, or as a partnership, which is taxable only at the level of the partners. US: Treas. Reg. Sec. 301.7701–3(a). If an eligible foreign entity has only one member, it may choose to be classified either as an association or as a disregarded entity. The election may be made at any time and it must comply with the formal requirements established by law ('entity classification election') jointly with its federal tax or information return of the taxable year in which the election is made. If the entity is not required to file a return for that year, i.e. attaching a copy of Form 8832 to the federal tax or information return of any direct or indirect owner of the entity for the taxable year in which the election is made. US: Treas. Reg. Sec. 301.7701–3(c)(1)(ii). For a further analysis of the check-the-box rules, *see* e.g. D. M. Benson et al., *'Hybrid' Entities: Practical Application Under the Check-the-Box Regime*, 26(8) Tax Mgmt. Int'l J. 363 (1997); B. N. Davis, *U.S. Tax Treatment of 'Reverse Hybrid' Foreign Entities*, 24(12) Tax Mgmt. Int'l J. 593–596 (1995); M. Gianni, *International Tax Planning After Check-the-Box*, 2 J. Passthrough Entities 9 (1999); P. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44(2) Cath. U. L. Rev. 437 (1995); H. Mogenson et al., *Hybrid Entities: Practical Application under the Check-the-Box Regime*, 23(1) Int'l Tax J. 4 (1997). For an analysis, *see also* Parada, *supra* n. 3, at 129–157.

[35] Navarro, Parada & Schwarz, *supra* n. 28, at 129.

[36] E.g. payments made to a reverse hybrid entity in cases where the reverse hybrid entity is not organized in the EU. The wording of Art. 9a suggests that those cases would not be within the scope of the Directive. However, some authors disagree with this statement. *See* e.g. G. K. Fibbe & A. J. A. Stevens, *Hybrid Mismatches Under the ATAD I and ATAD II*, 26(3) EC Tax Rev. 153, 165 (2017).

[37] European Commission, *Proposal for a Council Directivesupra* n. 28, Art. 10(1).

[38] This idea is also emphasized in Parada, *supra* n. 1.

[39] In these cases, it is evident that the source state and the state of the hybrid entity's establishment (the home state) will coincide. Therefore, it appears to be irrelevant to distinguish between a coordination rule according to the source state rules or according to the home state rules.

comes closer to a coordination rule granting supremacy to the rules in the home state of the relevant entity.[40]

The Spanish tax characterization system is based on the distinction between business and civil law entities for tax purposes, because while business entities are subject to Spanish corporate income tax, civil law entities are subject to a special regime, namely the income attribution regime.[41] Under this regime, entities are considered taxpayers. The income and the relevant taxes are therefore attributed to the partners of these entities who will bear the final tax burden.[42] The income attribution regime can also be applied to foreign entities the juridical nature of which is considered similar or identical to Spanish entities subject to the regime. Indeed, under Article 37 of the Non-Resident Income Tax Law (NRITL): 'Those entities incorporated abroad and the juridical nature of which is identical or analogous to those of entities subject to the income attribution regime, which are incorporated under Spanish Law, shall also be considered as entities subject to the attribution of income regime'.[43] As such, the Spanish law gives the impression – at least at first glance – of a simple resemblance test rather than a more elaborate coordination system as regards the tax characterization of foreign entities.[44] Nevertheless, a closer look at the interpretation of this provision by the Spanish tax administration (the Directorate-General for Taxation (DGT), *Ministerio de Hacienda*) leads one to a different conclusion. Indeed, there are plenty of examples of DGT responses to taxpayer consultations where the DGT has accepted that when the test of Article 37 of the NRITL is applied, the tax treatment of the entity given in the foreign country is the central element to consider in determining the tax characterization of the foreign entity in Spain.[45] In other words, when the Spanish test is applied in practice, it comes closer to a coordination rule than a resemblance test. This opinion is also widely supported in Spanish tax literature.[46]

Therefore, following the aforementioned interpretation of the income attribution regime (administrative practice of the DGT), there will be no possibilities for hybrid entity mismatches to arise in all cases where Spanish investors hold a participation in a foreign entity the tax characterization of which differs from that in Spain. For example if a foreign hybrid entity makes a payment to a Spanish entity controlling the foreign hybrid, such as in the example in Figure 1, the result will be that the foreign hybrid entity will be treated as a taxable entity in both Spain and the foreign state. Therefore, the interest deduction will be allowed in the foreign payer state, but a recognition of those payments as ordinary income will take place in Spain (payee state). This result should thus also satisfy those arguing for the taxation of income somewhere as a desirable tax policy result of transactions involving hybrid entities, even though such a result will still depend of the effective amount of income and expenses at the level of the recipient entity. Yet, it is evident that hybrid entity mismatches will still arise in the opposite situation, i.e. in all cases where a Spanish entity is characterized differently in a foreign state.[47]

Moreover, one could regard the Spanish administrative practice as fragile, i.e. there is no assurance that it will not change over time. Therefore, a statutory rule such as that proposed in section 3.1.1, which recognizes in part the long-standing tax administration practice in Spain, still appears to be a more desirable approach.[48]

Notes

[40] For further analysis, *see* s. 3.3.3.2.

[41] ES: Personal Income Tax Law, Law 35/2006 of 28 Nov. 2006 (*Ley de Impuesto a la Renta sobre las Personas Físicas* (LIRPF)), Art. 8.3.

[42] *Ibid.*

[43] ES: Non-Resident Income Tax Law (*Ley del Impuesto sobre la Renta de no Residentes*), Royal Legislative Decree 5/2004 of 5 Mar. 2004, Art. 37 (author's translation).

[44] The majority of countries opt for a comparative approach or 'resemblance test' to characterize foreign entities for tax purposes. Following this path, a foreign entity is regarded as a taxable or transparent entity depending on the level of comparability or equivalence to domestic taxable entities. Germany and the Netherlands are examples of countries applying this approach. For an explanation of the German resemblance test, *see* e.g. C. Kahlenberg, *Classification of Foreign Entities for German Tax Purposes* 54 Eur. Tax'n. 4 (2014). *See also* U. Henkel, *Subjektfähigkeit grenzüberschreitender Kapitalgesellschaften*, Recht der internationalen Wirtschaft (RIW) 7 (1991). For a general explanation of the Dutch resemblance test, *see* M. De Graaf & J. Gooijer, *Netherlands* in *Qualification of Taxable Entities and Tax Treaty Protection*, IFA Cahiers, Vol. 99B, 563 (IFA 2014). Before the implementation of the check-the-box regulations in 1996, the United States also characterized foreign entities for tax purposes based on a resemblance test (known as the 'Kintner test') that considered the concurrence of four corporate features, namely limited liability; continuity of life; centralized management, and free transferability of interests. *See* US: 14 Oct. 1954, *US v. Kintner*, 216 F2d 418 (9th Cir. 1954). For references as regards the US check-the-box regulations, *see supra* n. 34.

[45] E.g. ES: DGT, Consulta Vinculante V1398-16 of 5 Apr. 2016; DGT, Consulta Vinculante V3319-16 of 17 July 2016; DGT, Consulta Vinculante V3836-15 of 2 Dec. 2015; DGT, Consulta Vinculante V1631-14 of 25 June 2014; DGT, Consulta Vinculante V0012-11 of 11 Jan. 2011; DGT, Consulta General 0024–07 of 1 July 2007; DGT, Consulta General 0196–05 of 1 June 2005, among others. For a more detailed analysis of some specific decisions of the DGT, *see* Parada, *supra* n. 3, at 159–162.

[46] *See* e.g. D. Jiménez-Valladolid de L'Hotellerie-Fallois & F. Vega Borrego, *Spain*, in *Corporate Income Tax Subjects*, EATLP International Tax Series, vol. 12, 460–464 (D. Gutmann ed., 2016). *See also* A. Mosquera Mouriño, *Régimen de atribución de rentas: especial referencia a las actividades económicas*, (4) Carta Tributaria 3–16 (2012); Parada, *supra* n. 3, at 157–162.

[47] The afore-mentioned also reduces the complexity of the Spanish tax characterization test and increases the level of legal certainty for taxpayers involved in legitimate tax planning structures using hybrid entities. Parada, *supra* n. 3, at 162. In contrast, *see* M. Villar, *Spain* in *Qualification of Taxable Entities and Tax Treaty Protection*, IFA Cahiers Vol. 99B, 743 (IFA 2014).

[48] Indeed, if one considers that the current interpretation of the Spanish resemblance test deviates completely from the textual wording of the law, a new statutory rule would avoid any further conflicts. Parada, *supra* n. 3, at 162.

3.2 *Supremacy of the Tax Characterization Rules of the Residence State*

3.2.1 *The Proposal*

The second alternative for coordination in the tax characterization of entities would be to align the tax characterization of the relevant entity based on the tax characterization given in the residence state of the majority of the investors holding ownership in the relevant entity, independently of the original tax treatment of the entity in its state of establishment. In other words, this means giving supremacy to the tax characterization of the entity in the state where the majority of owners are considered tax residents.

As in the case of coordination granting supremacy to the tax characterization rules in the source state, this coordination rule could be introduced at a domestic level using the following wording:

> Where according to the rules of a State *A*, an entity is considered to be a taxable entity or a fiscally transparent entity, but more than 50% of its owners – directly or indirectly by shares or voting rights – are tax residents in State *B* where the entity is treated for tax purposes in the other way around, the tax treatment of the entity in State *A* will follow the one given in State *B*, i.e. the country of the owners holding more than 50% by shares or voting rights.

The implications of the rule will also depend on whether the situation involves hybrid or reverse hybrid entities, as well as whether the situation involves relevant payments made from or received by these entities. All of these implications are analysed below.

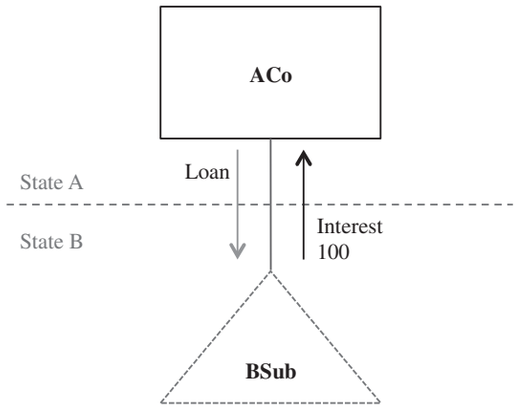
3.2.2 *Illustrations*

3.2.2.1 Cases Involving Hybrid Entities

Granting supremacy to the tax characterization rules in the state where the majority of the owners are residents may work very well in the context where a hybrid entity makes deductible payments to a related entity in another state where that payment is disregarded due to the tax transparency of the payer entity.

Consider again the simple bilateral hypothetical where ACo, a taxable entity incorporated in State *A*, grants a loan to BSub, an entity organized in State *B*. BSub pays interest in the amount of 100 connected to that loan.[49] Also assume that State *B* does not apply a withholding tax at source. Accordingly, while State *A* regards BSub as tax transparent, State *B* regards the same entity as a taxable or opaque entity.

Figure 8 Coordination in the Residence State And Deductible Payments Made by a Hybrid Entity



State A and State B will consider BSub as a fiscally transparent entity. The coordination at residence will eliminate the mismatch.

If a provision granting supremacy to the tax characterization rules in the state where the majority of owners are tax residents is applied, State *B* will follow the tax characterization of BSub in State *A* and will regard BSub as a tax transparent entity, as well (*see* above). This implies that no mismatch will arise as regards the tax characterization of BSub, because State *A* and State *B* will align their tax treatment as regards BSub. Accordingly, the transaction will result in a non-deduction/non-inclusion of income, because a deduction will no longer be available in State *B* where BSub is now treated as fiscally transparent. Likewise, no recognition of the interest as ordinary income will occur in State *A*, where BSub is also regarded as fiscally transparent, and therefore, the whole loan transaction is disregarded for tax purposes. This outcome should not be considered problematic at all, because it indeed produces the same result as applying a *primary response* under the current OECD linking rules.[50] Indeed, a primary response will deny a deduction in State *B* to the extent that the interest is not recognized as ordinary income in State *A*.[51] Yet, the difference is precisely that a coordination rule granting supremacy to the tax characterization rules in the state where the majority of owners

Notes

[49] The example also assumes that the loan is made at arm's length and that resulting interest is calculated and charged accordingly.

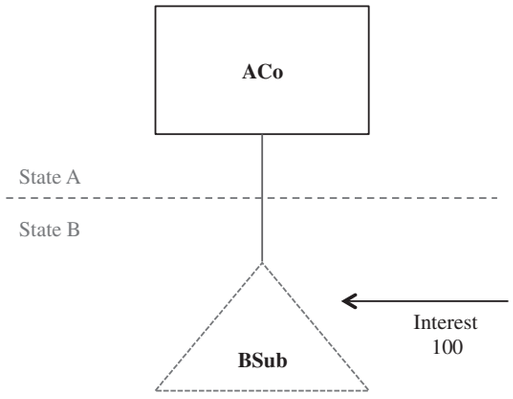
[50] As to the *primary response*, the OECD BEPS Action 2 Final Report states: 'In respect of such hybrid mismatch arrangements this report recommends that the response should be to deny the deduction in the payer jurisdiction'. OECD, *Action 2: 2015 Final Report, supra* n. 2, at 17. Accordingly, the OECD provides: '[…] the disregarded hybrid payments rule should only operate to the extent that the payer is entitled to a deduction for a payment under local law'. OECD, *Action 2: 2015 Final Report, supra* n. 2, at 51. For a critical analysis of the OECD linking rules as regards hybrid entity mismatches, *see* Parada, *supra* n. 1. *See also* Parada, *supra* n. 3, at 299–343. Also for a critical analysis of the OECD approach to hybrid entity mismatches and the implementation of linking rules, *see* Cooper, *supra* n. 1 and Lüdicke, *supra* n. 1.

[51] *See ibid.*

are residents requires less effort from the tax administration in applying it. Indeed, there is only one task for the tax administration in State *B* in this case, namely to determine the tax treatment of BSub in State *A*.[52] This is done without paying attention to whether or not payments where included as ordinary income in that state, which is indeed a requirement to deny a deduction under the OECD primary response.[53]

Similarly, the provision aims to apply to payments received by a hybrid entity, generating also positive results. Consider the example of Figure 8, with the only difference that BSub receives interest payments from a party in a third state. Regardless of what happens in the state from which the payment is sourced, the fact that BSub is regarded as a tax transparent entity by its single majority owner in State *A*, where this is a tax resident, will ensure that the interest payments flow through BSub and are recognized as ordinary income in State *A*. This outcome should thus also satisfy those arguing for ensuring single taxation of transaction involving hybrid entities. This also proves one of the main hypotheses of this article, namely that even though a rule granting supremacy to the tax characterization rules in the state where the majority of owners are residents is not based on the outcome of the transaction, it can be very effective in achieving such a result.[54]

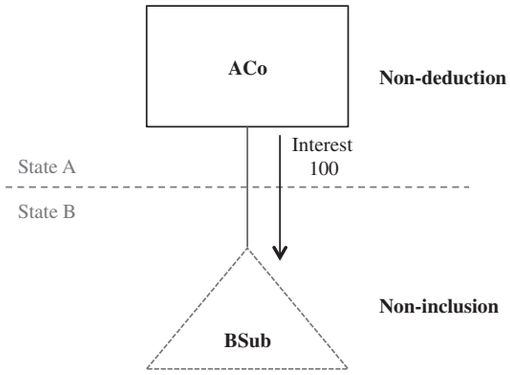
Figure 9 Coordination in the Residence State and Deductible Payments Made to a Hybrid Entity (Scenario 1)



State A and State B will consider BSub as a fiscally transparent entity. The coordination at residence will eliminate the mismatch and the interest payments will be recognized as income in State A.

A similar conclusion should be achieved if deductible payments are made from ACo to BSub, as illustrated below. Indeed, granting supremacy to the tax characterization rules in the state where the majority of owners are residents would mean that State *A* and State *B* will regard BSub as fiscally transparent. Therefore, the loan transaction will be completely disregarded by the two states involved, or similarly, the interest deduction will be no longer available in State *A* and no income will be recognized in State *B*.

Figure 10 Coordination in the Residence State and Deductible Payments Made to a Hybrid Entity (Scenario 2)



State A and State B will consider BSub as a fiscally transparent entity. The coordination at residence will eliminate the mismatch and the loan and interest payments will be disregarded in both State A and State B.

The outcome in Figure 10 might nonetheless raise the alarm amongst some in the international tax community. However, as already emphasized in this article, the use of double non-taxation as the core element in the design anti-hybrid rules is questionable and should be disregarded.[55] Yet, countries that still conclude that non-taxation will jeopardize their interests, might have the option to make the rule not applicable to these specific cases.[56]

3.2.2.2 Cases Involving Reverse Hybrid Entities

Granting supremacy to the tax characterization rules in the state where the majority of the owners are residents

Notes

[52] This certainly reduces the reliance on foreign law in comparison with the OECD linking rules. Parada, *supra* n. 3, at 314–316.

[53] For a further analysis of the OECD linking rules and hybrid entities, *see* Parada, *supra* n. 3, at 279 et seq.

[54] *See* s. 2.

[55] *See* hypotheses of this article at s. 2.

[56] An exception to the domestic provision granting supremacy to the tax characterization rules in the state where the majority of owners are residents in this case should not alter the international status quo, as transactions involving payments made to a hybrid entity were not originally considered within the scope of BEPS Action 2 Final Report either. OECD, *Action 2: 2015 Final Report, supra* n. 2, at 49, recommendation 3.2.

will have a similar outcome as granting supremacy to the tax characterization rules in the source state when deductible payments come from a party in a third state that regards a tax transparent entity as a taxable entity.-[57] This can be illustrated using again the example in Figure 4, i.e. assume that BSub is a reverse hybrid entity wholly owned by ACo, a company resident in State *A*, that receives interest from CSbub1, a sub-subsidiary established in a third State *C*.

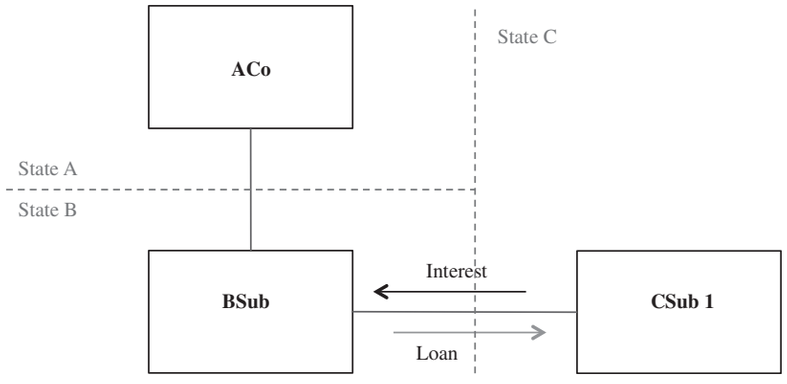
If one considers a provision granting supremacy to the tax characterization rules in the state where the majority of owners are residents, State *B* will follow the tax characterization of BSub based on that given in State *A*, i.e. where the majority of the investors treat the entity as a taxable entity. This solution will solve the hybrid entity mismatch and will ensure that the interest payments are recognized as ordinary income in State *B.*[58] This result should therefore also satisfy those arguing for ensuring single taxation in transactions involving hybrid and reverse hybrid entities. Yet, potential double taxation issues might still arise, particularly if State *A* decides to apply its CFC rules, as well. However, even in such a situation domestic relief could be granted, which is indeed a common worldwide practice.[59]

However, the outcome of granting supremacy to the tax characterization rules in the residence state may be more questionable where deductible payments are made from a reverse hybrid to a third state. This can be illustrated using the facts in Figure 11, with the sole difference that a payment of interest is made from BSub to CSub1.

A provision granting supremacy to the tax characterization rules in the state where the majority of owners are residents will imply that BSub will now be treated as a taxable entity in State *B.* Thus, a potential deduction for the interest payments will arise in State *B.* The outcome in State *C* will depend on the tax treatment of BSub in that state. If BSub is also regarded as a taxable entity in State *C*, there will be recognition of the interest as ordinary income in State *C.* However, if BSub is regarded as fiscally transparent in State *C*, the final outcome will be a deduction/non-inclusion, which could raise the alarm amongst an important portion of international tax scholars, even though for purposes of all the three proposals for coordination in this article, it does not represent a concern at all. Yet, this author recognizes that double non-taxation in this case arises exclusively due to the application of the proposed coordination rule. Thus, countries could still opt not to apply the provision. This exception could be included in domestic law together with the main coordination provision.

Consider the following analysis of the impact of a provision granting supremacy to the tax characterization rules in the state where the majority of the owners are residents in the case of reverse hybrid entities making payments to the state where the owners controlling the entity are located. Assume that BSub is a reverse hybrid entity wholly owned by ACo, a company resident in State *A*, which receives interest from BSub. Disregard the existence of a third State *C*, which is irrelevant for purposes of this illustration.

Figure 11 Coordination in the Residence State and Payments Received by a Reverse Hybrid Entity



Notes

[57] *See* s. 3.1.2.2.

[58] This solution is also interesting from the perspective of generating tax revenue, because the fact that the entity (BSub) is recharacterized for tax purposes from a tax transparent entity to a taxable entity will ensure that tax revenue stays in the state of the entity (State *B* in the example). This is perhaps also the reason why this rule was also introduced in Art. 9a of the EU ATAD 2. EU Anti-Tax Avoidance Directive (ATAD 2): Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries OJ L144/1 (7 July 2017). For a further analysis, *see* s. 3.2.3.3.

[59] An example at *supra* n. 14.

Figure 12 Coordination in the Residence State and Payments Made by a Reverse Hybrid Entity to a Third Country

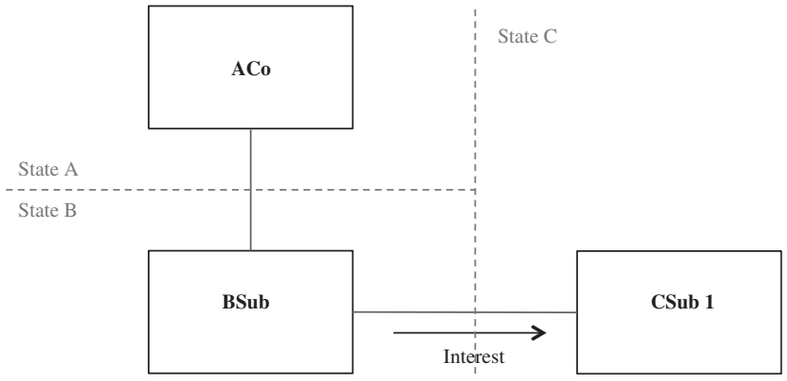
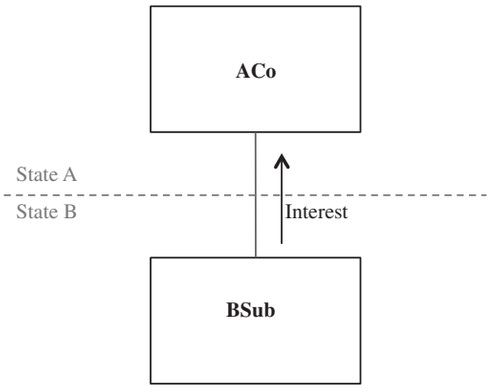


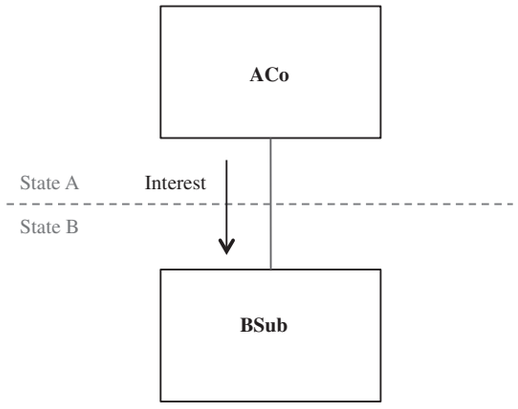
Figure 13 Coordination in the Residence State and Payments Made by a Reverse Hybrid Entity to Its Controlling Investor



Coordination in the residence state means that BSub is considered a taxable entity both in State A and State B. The outcome will thus be a deduction/inclusion of income.

As noted, a provision granting supremacy to the tax characterization rules in the state where the majority of owners are residents means in this case that State *A* and State *B* will regard BSub as a taxable entity. Therefore, the interest will be deductible in State *B* while the interest will be recognized as ordinary income in State *A*. The same outcome will appear if BSub (a reverse hybrid) receives deductible payments from the investors (ACo), i.e. a deduction/inclusion will arise, as the coordination rule provides for coordination based on the tax treatment in State *A* where BSub is regarded as a taxable entity.

Figure 14 Coordination in the Residence State and Payments to a Reverse Hybrid Entity by Its Controlling Investor



Thus, in both cases a provision granting supremacy to the tax characterization rules in the state where the majority of owners are residents should be seen positively. First, it solves the hybrid entity mismatch in its origin, i.e. there will no longer be a disparate tax characterization of BSub. Second, it appears to give rise to an outcome that should equally satisfy both sceptics and non-sceptics of single taxation as regards transactions involving hybrid and reverse hybrid entities. Indeed, the application of this proposal proves to be very effective in achieving a single taxation result, even though the proposal does not focus on achieving such an outcome.[60]

3.2.3 *Practical Examples in Support of this Proposal*

Some examples of provisions granting supremacy to the tax characterization rules in the state where the majority of owners are tax residents can be found in

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[60] *See* s. 3.

both existing law and recommendations for future legislation. The discussion below considers the Danish anti-hybrid rules, Recommendation 5.2 of the BEPS Action 2 Final Report and Article 9a of the EU ATAD 2. The ultimate aim of this section is not to provide an in-depth analysis of these specific provisions, but rather to offer a practical approach to the hypothetical analysis already carried out in section 3.2.2.

3.2.3.1 Danish Anti-Hybrid Entity Rules

Danish tax law provides some specific rules designed to counteract cases involving hybrids and reverse hybrid entities, especially motivated by transactions with US investors.[61]

Regarding hybrid entities, Danish tax law provides that a domestic taxable entity will be recharacterized as a tax transparent entity if certain requirements are met,[62] namely (1) the taxable entity is an entity resident in Denmark or a PE of a foreign resident company, (2) the Danish taxable entity is disregarded for foreign tax purposes, (3) the income of the Danish company is included in the taxable income of the controlled foreign legal entity, i.e. an entity that owns more than 50% of the Danish company or holds more than 50% of the voting rights in a Danish company and (4) the foreign country is a member of the European Economic Area (EEA) or a tax treaty partner of Denmark.[63] If all these requirements are satisfied, the entity (i.e. the Danish entity) will be treated as a branch of the controlled foreign legal entity.[64] As to reverse hybrid entities, Danish tax law provides for a recharacterization of Danish tax transparent entities as taxable entities if certain requirements are met, namely that (1) the direct owners/partners holding more than 50% of the capital or voting rights are tax residents in one or more foreign jurisdictions, the Faroe Islands or Greenland[65] and (2) the jurisdiction in which the owners are tax resident either regards the Danish entity as a separate taxable entity or it does not exchange information with the Danish tax authorities.[66]

The Danish anti-hybrid rules still leave open questions regarding their true effectiveness.[67] For example the Danish rules require that a domestic taxable entity be recharacterized as tax transparent so that the income of a Danish entity is included in the parent company (US parent), which is assumed to be a controlled foreign entity. Therefore, no recharacterization will occur in all cases where the Danish company has no operating income in a specific taxable year.[68] Moreover, the Danish rules do not clarify whether they apply in cases of a US taxpayer considering the Danish entity as tax transparent, although without making use of the check-the-box election,[69] for example due to the default rules of classification in the United States.[70]

However, and all in all, the Danish anti-hybrid entity mismatch rules represent a concrete example of how granting supremacy to the tax characterization rules in the residence state of the majority of the investors holding ownership in the entity is indeed a more direct and substantial way to deal with issues concerning hybrid entity mismatches.

Notes

[61] These rules were indeed a targeted reaction to the characterization of entities derived specifically from the use of the check-the-box regulations in the United States. A. Møllin Ottosen & M. Nørremark, *New Anti-Avoidance Rules in Denmark Targets Reverse Hybrids and Convertible Bonds*, 62(11) Bull. Int'l Tax'n 513 (2008). *See also* J. Bundgaard, *Coordination Rules as a Weapon in the War against Cross-Border Tax Arbitrage: The Case of Hybrid Entities and Hybrid Financial Instruments*, 67(4/5) Bull. Int'l Tax'n 200–201 (2013). For an explanation and references as regards the US check-the-box rules, *see supra* n. 34.

[62] DK: s. 2A Corporate Income Tax Law [*Selskabsskatteloven* (SEL)], adopted by Bill 119 of 17 Dec. 2003. *See also* J. Wittendorff, *Denmark's Hovmand Clarifies Pending Transparent Entities Legislation*, 33(9) Tax Notes Int'l 758 (2004). *See also* Dell'Anese, *supra* n. 5, at 254.

[63] J. Wittendorff, *Danish Parliament Enacts Transparent Entity Legislation*, 34 Tax Notes Int'l 1 (2004). *See also* Wittendorff, *supra* n. 62.

[64] This does not mean that the entity is now entitled to claim a deduction for payments made to the foreign parent company or to group-related entities also treated as fiscally transparent under the law of the residence state of the foreign company. In addition, dividends paid from the Danish entity to the foreign controlled legal entity are not subject to withholding tax. *See* A. Riis & P. E. Lytken, *Denmark-Corporate Taxation*, s. 10, Country Analyses IBFD (accessed 16 Sept. 2018). However, as Wittendorff states: '[…] if there is a direct link between external borrowings by the foreign parent company and the loan granted to the transparent entity, the interest paid by the foreign parent should be allocable to the transparent entity in accordance with ordinary principles of PE taxation'. Wittendorff, *supra* n. 62. *See also* Dell'Anese, *supra* n. 5, at 254–255.

[65] There direct owners do not need to be affiliated parties. They may indeed be separate companies or individuals that reside in foreign countries and which together hold more than 50% of the capital or voting power. Likewise, non-Danish entities and branches that are treated as tax transparent in their country of organization are disregarded for purposes of determining direct ownership. This is especially relevant in the case where a taxpayer decides to use an intermediary company between the US owners and the Danish transparent entity, which is deemed to be transparent in its country of organization but a taxable entity in the United States. In such a case, the entity is disregarded for purposes of determining who is the direct owner of the Danish entity. Møllin Ottosen & Nørremark, *supra* n. 61, at 514.

[66] An exception applies as regards venture funds investing in medium and small-sized companies. Bundgaard, *supra* n. 61, at 202.

[67] For a complete analysis of this matter, *see* Parada, *supra* n. 3, at 162–172.

[68] Parada, *supra* n. 3, at 164.

[69] For references to the US check-the-box regulations, *see supra* n. 34.

[70] In the absence of an election, the tax status of a foreign business in the United States is settled by default rules based on limited liability and the number of owners of the foreign entity. US: Treas. Reg. Sec. 301.7701–3(c)(1)(iv). I.e. a foreign eligible entity will be considered a partnership if it has two or more members and at least one of them does not have limited liability; as an association taxable as a corporation, if all members have limited liability; and as a disregarded entity if an eligible entity has a single owner who does not have limited liability. US: Treas. Reg. Sec. 301.7701–3(b)(2)(1)(A),(B) & (C). For an explanation of the check-the-box rules in the United States, *see supra* n. 34.

3.2.3.2 Recommendation 5.2 of the OECD BEPS Action 2 Final Report

A rule similar to the Danish tax rule on reverse hybrid entities was recommended as part of the OECD BEPS Action 2 Final Report.[71] According to Recommendation 5.2, the tax transparency treatment of an entity in its country of establishment should be limited, such that a tax transparent entity should be rather treated as a taxable entity in the country of its establishment to the extent that such entity derives foreign source income that is not otherwise subject to taxation in the country of its establishment and that such income is allocated under the domestic law of that country (country of establishment) to non-resident investors that are in the same control group as the reverse hybrid entity.[72] Indeed, as stated in the text of the Action 2 Final Report:

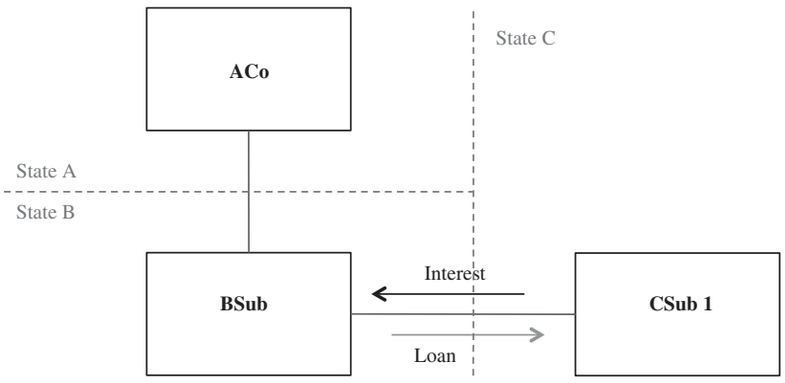
> The recommendation only applies in circumstances where: a) the person is tax transparent under the laws of the establishment jurisdiction; b) the person derives foreign source income or income that is not otherwise subject to taxation in the establishment jurisdiction; c) all or part of that income is allocated under the laws of the establishment jurisdiction to a non-resident investor that is in the same control group as that person.[73]

This can be illustrated using the facts of Figure 11. Assume therefore that BSub, a tax transparent entity established in State *B* and wholly owned by ACo, a company resident in State *A*, receives interest payments from CSbub1, a sub-subsidiary that is established in a third State *C*.[74]

In this case, all the requirements for the application of Recommendation 5.2 would be met. First, there is a person (BSub) that is regarded as tax transparent under the laws of the state of establishment (State *B*). Second, that person derives foreign-source income (interest from State *C*) that is not otherwise subject to taxation in the establishment jurisdiction (State *B*). Indeed, as State *B* regards BSub as fiscally transparent, there is no taxation of that income in State *B*. Third, the establishment jurisdiction (State *B*) allocates the income to a non-resident (ACo) that is in the same control group as that person (BSub). Therefore, the tax transparency treatment of BSub in State *B* will limited to treat BSub as a taxable entity in State *B*. In other words, Recommendation 5.2 appears to be a rule granting priority to the tax characterization of the entity in the state where the majority its investors are residents – very similar to the Danish rule analysed above.[75] As to the outcome of its application, it eliminates the mismatch as regards the tax characterization of BSub and ensures that the interest payments are recognized as income in State *B*.

Nevertheless, Recommendation 5.2 still leaves some open questions. First, and as emphasized elsewhere by this author,[76] such a rule should be properly coordinated

Figure 15 Recommendation 5.2 of the OECD BEPS Action 2 Final Report



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[71] OECD, *Action 2: 2015 Final Report, supra* n. 2, at 64–65.

[72] The BEPS Action 2 Final Report states: 'Two persons are in the same control group if: (1) they are consolidated for accounting purposes; (2) the first person has an investment that provides that person with effective control of the second person or there is a third person that holds the investment which provides that person with effective control over both persons; (3) the first person has a 50% or greater investment in the second person or there is a third person that holds a 50% or greater investment in both; or (4) they can be regarded as associated enterprises under Art. 9 [of the OECD Model]'. OECD, *Action 2: 2015 Final Report, supra* n. 2, at 113.

[73] OECD, *Action 2: 2015 Final Report, supra* n. 2, at 113.

[74] The example also assumes that the loan is made at arm's length and that resulting interest is calculated and charged accordingly.

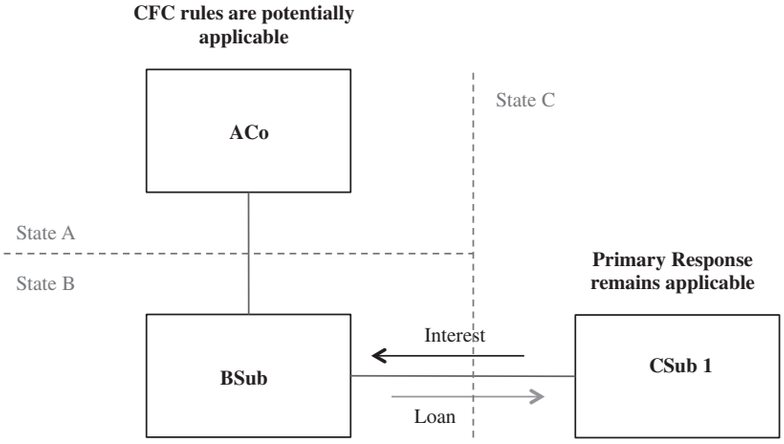
[75] However, unlike the Danish rule, the OECD does not make any references to the lack of information exchanged between the state of the investors and the entity's state of establishment as a factor to trigger the application of the rule. This appears indeed to be a unique feature of the Danish tax law. *Supra* n. 66.

[76] Parada, *supra* n. 1.

with the application of CFC rules in the state of the investors controlling the reverse hybrid entity. Indeed, taking the example in Figure 15, nothing prevents the application of CFC rules by State *A* – which might ultimately give rise to double taxation.[77] Second, and unlike this author's proposals, Recommendation 5.2 is not designed to replace the OECD linking rules, but rather to coexist with them. This could bring new problems to the table. For example if, as in the Figure 15, State *C* introduces linking rules, nothing would prevent State *C* from denying an interest deduction before the application of Recommendation 5.2, even though the interest would also be included as ordinary income in State *B* by the recharacterization of BSub as a taxable entity. In other words, economic double taxation would arise. Both issues are illustrated below.

Other concerns as regards Recommendation 5.2 refer to issues of legal certainty and non-discrimination.[78] Indeed, considering that tax transparency is an effective way to attract foreign investors and to ensure tax neutrality among them, non-resident taxpayers might be rightfully concerned by the fact that electing to do business in a country through a tax transparent entity does not guarantee that in the future such tax transparency will be respected. This could ultimately reduce the attractiveness of investment in that place.[79] Similarly, implementing a rule that provides for a recharacterization of a tax transparent entity only as regards non-resident investors might be considered discriminatory.[80] This is especially relevant in the context of the European Union and fundamental freedoms.[81]

Figure 16 Recommendation 5.2, CFC Legislation and OECD Linking Rules



The tax transparency treatment of BSub in State B is replaced by treating BSub as a taxable entity. Interest are thus included as ordinary income.

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[77] This issue is recognized in the BEPS Action 2 Final Report when it states: 'By treating the entity as a resident taxpayer, this will eliminate the need to apply the reverse hybrid rule to such entities and the investor jurisdiction could continue to include such payments in income under Recommendation 5.1 but provide a credit for any taxes paid in the establishment jurisdiction on the income i.e. brought into account under such rules'. OECD, *Action 2: 2015 Final Report, supra* n. 2, at 65. This potential double taxation issue was also already emphasized in s. 3.2.2.2. In practice, however, granting relief from double taxation if income received by the reverse hybrid (now a taxable entity by application of recommendation 5.2) is taxed also in the state where the majority of the investors are residents, should not be the true concern, especially because most countries around the world provide for relief in the case of double taxation. *See* e.g. *supra* n. 14.

[78] This has been also emphasized elsewhere by this author. Parada, *supra* n. 1.

[79] E.g. in the United States the taxation of partnerships or pass-through entities is certainly more beneficial, especially because of the avoidance of economic double taxation. As McDaniel et al. has stated: 'Since the partnership is treated as a conduit for tax purposes, profits are taxed only once, in contrast to the taxation of corporate profits, first when earned by the corporation, and again, when distributed to shareholders'. P. McDaniel, M. McMahon, Jr. & D. Simmons, *Federal Income Taxation of Partnerships and S Corporations* 1 (4th ed., Foundation Press 2006).

[80] Even if Recommendation 5.2 were to be applicable without distinguishing between resident and non-resident taxpayers, such a measure might not ensure that hidden or tacit discrimination still exists. Indeed, hybrid entity mismatches can arise only in cross-border situations. Parada, *supra* n. 1. In a similar opinion, but analysing the OECD linking rules, *see* A. Rust, *BEPS Action 2: 2014 Deliverable – Neutralizing 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*, 3 Brit. Tax Rev. 313, 320 (2015).

[81] The ECJ conducts an analysis involving different phases in order to determine whether a national rule might be viewed as discriminatory. First, the ECJ determines which of the fundamental freedoms is indeed potentially infringed. Second, and once this analysis has been completed, the Court compares the situation of the complaining taxpayer (normally a non-resident with economic connection with the host country) with a comparable domestic situation in order to determine whether these two situations are treated equally. If the result of this second phase is that the national rule is discriminatory, there must still be justifications grounds for discrimination. Finally, the third stage involves a test of proportionality. I.e. even if a justification ground justifies the discriminatory measure, the rule must be regarded as proportional. R. Mason & M. Knoll, *What Is Discrimination?* 121(5) Yale L. J. 1014 (2012). For an in-depth analysis of the principle of non-discrimination under EU Law, *see* N. Bammens, *The Principle of Non-Discrimination in International and European Tax Law*, IBFD Doctoral Series, vol. 24 (IBFD 2012).

Finally, and although beyond the limited scope of this article, one should bear in mind that Recommendation 5.2 could also have an impact on tax treaties, especially as regards the application of the new Article 1(2) of the OECD Model.[82] Generally speaking, Article 1(2) of the OECD Model helps to determine who should be entitled to the benefits of a bilateral tax treaty when an item of income is received by or through a tax transparent entity treated as such by one or both contracting states.[83] If that is the case, Article 1(2) of the OECD Model will grant treaty benefits to the residents of the state treating the entity as tax transparent, who are normally the owners or partners of the entity, at least in the case of a partnership.-[84] Therefore, it is evident that if a state limits the tax transparency of an entity so as to treat it as a taxable entity (Recommendation 5.2), this will impact in the scope of Article 1(2) and the general application of the income tax treat treaty between the state of the investors' residence and the source state in a triangular situation like that illustrated in Figure 16. In such a case, both contracting states will regard the entity receiving the income as a non-transparent entity. Therefore, Article 1(2) of the OECD Model would no longer be necessary.

This should not necessarily be viewed as something negative, especially because the outcomes of Article 1(2) of the OECD Model are not always desirable.[85] A similar effect as regards tax treaties can be achieved with respect to the Danish anti-hybrid rules[86] and Article 9a of the ATAD 2.[87]

All in all, and as noted, while Recommendation 5.2 is not an unassailable solution, it is a very positive step in the right direction, especially towards achieving more fundamental solutions as regards reverse hybrid entity mismatches.[88]

3.2.3.3 EU ATAD 2: Article 9a (reverse hybrids)

Article 9a of the EU ATAD 2 deals with cases where a deductible payment is received by a tax transparent entity established in an EU Member State while the same entity is treated by the majority of its owners, located in a non-EU Member State, as a taxable entity. In other words, it refers specifically to cases of reverse hybrid entities receiving deductible payments.[89]

The rule works in a very similar way as the proposal explained in section 3.2.1, namely that the entity in the

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[82] For a complete analysis of the new Art. 1(2) of the OECD Model, *see* A. Nikolakakis et al., *Some Reflections on the Proposed Revisions to the OECD Model and Commentaries, and on the Multilateral Instrument, with respect to Fiscally Transparent Entities*, Brit. Tax Rev. 3 (2017), republished in two parts as A. Nikolakakis et al., *Some Reflections on the Proposed Revisions to the OECD Model and Commentaries, and on the Multilateral Instrument, with Respect to Fiscally Transparent Entities – Part 1*, 71 Bull. Int'l Tax'n 9 (2017) and A. Nikolakakis et al., *Some Reflections on the Proposed Revisions to the OECD Model and Commentaries, and on the Multilateral Instrument, with Respect to Fiscally Transparent Entities – Part 2*, 71 Bull. Int'l Tax'n 10 (2017). More recently, for a critical analysis of the impact of Art. 1(2) of the OECD Model, *see* D. Sanghavi, *BEPS Hybrid Entities Proposal: A Slippery Slope, Especially for Developing Countries*, 85 Tax Notes Int'l 4 (2017); D. Sanghavi, *Structural Issues in the Income Tax Treaty Network: Towards a Coherent Framework* 270–272 (Maastricht PhD thesis 2018). More recently in this critical approach as regards Art. 1(2) of the OECD Model, *see* Parada, *supra* n. 4.

[83] Art. 1(2) of the OECD Model reads as follows: 'For the purposes of this Convention, income derived by or through an entity or arrangement i.e. treated as wholly or partly fiscally transparent under the taxation law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of the taxation by that State, as income of a resident of that State'. *OECD Model Tax Convention on Income and Capital: Condensed Version 2017* (OECD Publishing 2017). This wording resembles Art. 1(6) of the US Model in the 2006 and 2016 versions, which were the first positive recognitions of the principles settled by the OECD Partnership Report in 1999. For the text of Art. 1(6) US Model 2006, *see* US: Dept. of the Treasury, *United States Model Income Tax Convention of 15 November 2006*, Art. 1(6) & *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of 15 November 2006.* For the 2016 text, *see* United States Model Income Tax Convention of 17 Feb. 2016, Art. 1(6). A technical explanation of the 2016 US Model has not been published at the time of writing. For a comparative analysis of both the OECD Model and US Model provisions, *see* e.g. J. Kollmann, A. Roncarati & C. Staringer, *Treaty Entitlement for Fiscally Transparent Entities: Art. 1(2) of the OECD Model Convention*, in *Base Erosion and Profit Shifting (BEPS): The Proposals to Revise the OECD Model Convention* (M. Lang, P. Pistone, A. Rust et al. eds, Linde 2016). For the 1999 OECD Partnership Report, *see* OECD, *The Application of the OECD Model Tax Convention to Partnerships* (OECD Publishing 20 Jan. 1999). For criticism of the OECD Partnership Report, *see* M. Lang, *The Application of the OECD Model Tax Convention to Partnerships, A Critical Analysis of the Report Prepared by the OECD* (Wolters Kluwer 2000). *See also* R. Danon, *Qualification of Taxable Entities and Treaty Protection*, 68 Bull. Int'l Tax'n 4/5 (2014). For a more recent analysis of the principles of the 1999 OECD Partnership Report, *see* H. Ault, *The Partnership Report Revisited: BEPS, the Multilateral Convention, and the 2017 OECD Model* Convention, in *Tax Treaties After the BEPS Project: A Tribute to Jacques Sasseville*, 23–26 (B. J. Arnold ed., Canadian Tax Foundation 2018).

[84] '[…] Art. 1(2) of the OECD Model simply determines who should be entitled to the benefits of a double tax treaty. Therefore, there will always be the need to look at the specific provision governing the allocation of taxing rights within the treaty in order to ascertain whether or not the tax treaty benefits are finally granted'. Parada, *supra* n. 4, at 343.

[85] Parada stresses two main issues as regards the application of Art. 1(2) of the OECD Model. First, Art. 1(2) of the OECD Model would not be appropriately designed to interact with other distributive rules, especially with the beneficial ownership requirement in Arts 10, 11 and 12 of the OECD Model. Sanghavi has also made reference to this issue in what he calls the 'economic anomalies' of Art. 1(2) of the OECD Model. Sanghavi, *BEPS Hybrid Entities Proposal*, *supra* n. 82, at 361–362 (Figure 2). Second, Art. 1(2) of the OECD Model would maintain an unjustified preference for the interests of the residence state over those of the source state. For a full analysis, *see* Parada, *supra* n. 4, at 349–357.

[86] *See* s. 3.2.3.1.

[87] *See* s. 3.2.3.3.

[88] Parada, *supra* n. 1.

[89] Art. 9a of the ATAD 2 reads as follows: 'Where one or more associated non-resident entities holding in aggregate a direct or indirect interest in 50% or more of the voting rights, capital interests or rights to a share of profit in a hybrid entity i.e. 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 this income is not otherwise taxed under the laws of the Member State or any other jurisdiction'. Art. 9a(1) Council Directive 2017/952/EU of 29 May 2017 (ATAD 2). For a further analysis of Art. 9a of the ATAD 2, *see* Fibbe & Stevens, *supra* n. 36. The first proposal of the EU ATAD 2 was issued on 25 Oct. 2016. Subsequently, it derived in a second draft published on 2 Dec. 2016. A final text was made public on 17 Feb. 2017, which was accepted by the European Council during the ECOFIN meeting of 21 Feb. 2017. *See* European Commission, *Proposal for a Council Directive amending Directive 2016/1164/EU as regards hybrid mismatches with third countries*, COM (2016) 687 final, (25 Oct. 2016). *See also* Council of the European Union, *Proposal for a Council Directive amending Directive 2016/1164/EU as regards hybrid mismatches with third countries*, 6333/17 FISC 46 ECOFIN 95, (17 Feb. 2017). The text of 29 May 2017 did not vary from that of 17 Feb. 2017.

EU is recharacterized for tax purposes in order to avoid a hybrid entity mismatch. That is, this is a coordination rule that grants priority to the tax characterization rules in the state where the majority of the investors are residents, which is indeed a deviation from the OECD approach of matching tax outcomes.[90] Yet, unlike the proposal in section 3.2.1 of this article, Article 9a of the EU ATAD 2 still possesses a very consequentialist approach. As noted in the wording of the provision, the EU fiscally transparent entity will be treated as a taxable one ' … to the extent that this income is not otherwise taxed under the laws of the Member State or any other jurisdiction'.[91] Therefore, double non-taxation still appears to be a necessary condition for the application of the rule.

There is a similarity between the anti-hybrid rule in the EU ATAD 2 on the one hand, and the Danish anti-reverse hybrid rule[92] and Recommendation 5.2 of the BEPS Action Plan on the other.[93] Indeed, all of these rules not only share a similar wording, but also target the core issue regarding hybrid entity mismatches, namely the disparate tax characterization of the entities. This is particularly relevant, as the application of Article 9a of the EU ATAD 2 appears to take priority over the rule contained in Article 9(2) of the EU ATAD 2, i.e. linking rules. This hierarchy would also confirm that, at least in cases involving reverse hybrid entity mismatches, there would be no need to rely on the OECD linking rules.[94]

Although Article 9a of the EU ATAD 2 is not entirely effective,[95] it is another significant example where a rule granting supremacy to the tax characterization rules in the state where the majority of the investors are residents, makes more sense than a rule based exclusively on matching tax outcomes, especially in a coordinated regional context such as the European Union.[96]

3.3. *Supremacy of the Tax Characterization Rules of the Home State*

3.3.1 *The Proposal*

This concept was recently proposed in the international tax literature and might work as a very suitable alternative to the current OECD linking rules.[97] Generally speaking, the proposal relies on a domestic rule that aligns the tax characterization of foreign entities for domestic tax purposes in accordance with the tax characterization given to them in the country where the relevant entity is formally and legally established or incorporated, i.e. the home state. This rule could be introduced as a domestic rule using the following wording:

> Where according to the rules of a State, a different tax characterization is given to the same entity, the tax characterization given to the entity by the State where the entity is legally and formally organized, shall be followed by the other State.[98]

The whole idea of granting supremacy to the tax characterization rules in the home state, i.e. where the entity is legally and formally organized, will avoid any confusion regarding source and home countries, as both categories might not necessarily coincide when one refers to hybrid

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[90] Taking a similar position, *see* Fibbe & Stevens, *supra* n. 36, at 164. It also resembles Recommendation 5.2. of the Action 2 Final Report. OECD, *Action 2: 2015 Final Report, supra* n. 2, at 64–65. *See also* s. 3.2.3.2.

[91] *See* s. 3.2.3.1.

[92] *Ibid.*

[93] *See* s. 3.2.3.2.

[94] This seems to be confirmed in recital 29 of the preamble of the Directive, which provides: 'The hybrid mismatch rules in Art. 9(1) and (2) only apply to the extent that the situation involving a taxpayer gives rise to a mismatch outcome. No mismatch outcome should arise when an arrangement is subject to adjustments under Art. 9(5) or 9a and, accordingly, arrangements that are subject to adjustment under those parts of this Directive should not be subject to any further adjustment under the hybrid mismatch rules'. EU ATAD 2, rec. 29. This seems also to be the rule when CFC rules might solve the reverse hybrid entity mismatch first. According to recital 30 of EU ATAD 2: 'Where the provisions of another directive, such as those in Council Directive 2011/96/EU (EU ATAD 1), lead to the neutralization of the mismatch in tax outcomes, there should be no scope for the application of the hybrid mismatch rules provided for in this Directive'. Id., rec. 30. This is also confirmed in the OECD BEPS Action 2 Final Report. OECD, *Action 2: 2015 Final Report, supra* n. 2, at 64.

[95] E.g. the rule is not effective to resolve cases where the tax transparent entity is organized in a non-EU Member State, even though the EU investors own more than 50% of the entity, and it receives payment from either a non-EU state or an EU Member State. In such cases, the mismatch will be avoided either by the application of CFC rules in the country in which the investors are resident, or by reliance on the OECD primary response in the country in which the payer is resident. For further analysis, *see* Fibbe & Stevens, *supra* n. 36, at 165.

[96] For a more in-depth analysis of Art. 9a of the ATAD 2, *see* Parada, *supra* n. 3, at 181–184. *See also* Parada *supra* n. 1.

[97] The proposal relies on three main tax policy aims, namely (1) simplicity, (2) coherence and (3) ease of administration, and it attempts to be a suitable alternative to the OECD linking rules. For a full comprehensive analysis of this proposal, *see* Parada, *supra* n. 3, at 353–398.

[98] The proposal does not attempt to harmonize the characterization of entities around the world, but rather to create a rule that allows a 'coordinated reaction' when dealing with hybrid and reverse hybrid entities ('reactive coordination rule'). Parada, *supra* n. 3, at 354. In addition, the proposed rule does not attempt to coordinate the legal characterization of entities in the sense of the existence of entities for all legal purposes. Instead, the subject of coordination proposed by the rule is the specific tax characterization given to legal entities in different jurisdictions, which is indeed the reason for the existence of hybrids and reverse hybrid entities. This clarification is necessary, as the proposed wording for the rule might be erroneously interpreted as coordination of the legal characterization when it states: ' … the tax characterization given to that entity where the entity is organized … ', especially because of the reference to 'where the entity is organized'. Nevertheless, the clear reference to 'tax characterization' and not 'legal characterization' of an entity makes evident the target of the rule. This is critical to avoid confusion in those countries where the legal characterization and tax characterization of the entities will not necessarily coincide.

and reverse hybrid entity structures.[99] Accordingly, it possesses the advantage of certainty, as the place where the entity is formally and legally organized (home state) is – by default – only one place, even in cases of legal entities organized at a supranational level, because even in those cases there is ultimately still a reference to one jurisdiction.[100] More importantly, the rule will provide a more direct approach to deal with hybrid entities in which disparities in the tax characterization will become the central element in the design of the rule, also reducing the contingency and complexity of its application.[101] Nonetheless, special attention should be paid to the aim not to generate improper tax planning incentives and new abusive practices.[102]

The specific implications of this proposal must be distinguished between cases involving hybrid and reverse hybrid entities and relevant payments made from or received by these entities. These implications are analysed below.

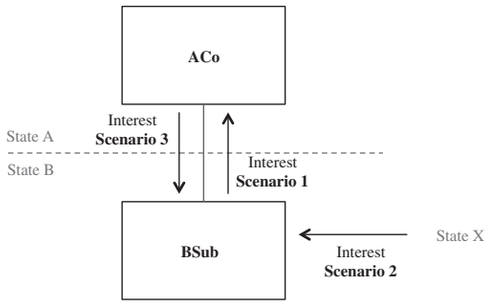
3.3.2 *Illustrations*

3.3.2.1 Cases Involving Hybrid Entities

Granting supremacy to the tax characterization rules in the home state will eliminate any possibility of mismatches as regards the tax characterization of the same entity between two jurisdictions. In other words, the issue of hybrid entities will be reduced practically to zero.[103] Notably, also, in all the cases involving hybrid entities either making a deductible payment or receiving it, the tax outcome will be a deduction/inclusion. Therefore, granting supremacy to the tax characterization rules in the home state should also satisfy those concerned about single taxation.

Assume that BSub is an entity legally and formally organized as a corporation in State *B*. Accordingly, BSub is controlled by ACo, a corporation legally and formally organized in State *A*. While State *B* treats BSub as a taxable entity, State *A* regards BSub as a tax transparent entity. Assume three scenarios: (1) BSub makes deductible interest payments to ACo, (2) BSub receives deductible interest payments from a third party in State *X* and (3) BSub receives deductible interest payments from ACo in State *A*.

Figure 17 Coordination in the Home State and Hybrid Entities (Scenarios 1, 2 and 3)



Coordination in the 'home state' means that BSub will be considered as a taxable entity in all States involved in the transaction. The outcome in the case a hybrid entity makes or receives a payment will thus always be a deduction/inclusion under the application of this coordination rule.

Granting supremacy to the tax characterization rules in the state where the entity is legally and formally organized (i.e. State *B*) means that State *A* – *Scenario 1* and *Scenario 3* – and State *X* (source state of the interest) – *Scenario 2* – will follow the tax characterization of BSub in State *B*, where the entity is treated as a taxable entity. Therefore, in all the three hypotheticals, the hybrid entity mismatch is not only eliminated, but the interest will also be included as income in at least one state. This proves one of the main hypotheses of this article, namely that even though a rule granting supremacy to the tax characterization rules in the home state is not designed based on the outcome of the transaction (particularly, double non-taxation), it can be very effective in achieving a single tax result.[104]

Notes

[99] E.g. while the source state and home state coincide in all those cases where a hybrid entity makes a payment, they do not do so when the hybrid entity receives a payment. Similarly, whilst the home and source countries of a reverse hybrid making a payment might be the same, these two categories do not coincide when a reverse hybrid entity receives a payment. This therefore reaffirms the idea of referring to the home state. Parada, *supra* n. 3, at 356.

[100] E.g. the European Company (SE), the European Cooperative Society (SCE) or the European Economic Interest Grouping (EEIG) are legal forms that, to a large extent, are governed by uniform EU law, but which are still partly regulated by the national provisions of the MS of incorporation. *See* Council Regulation (EC) No 2157/2001 of 8 Oct. 2001 on the Statute for a European company (SE), OJ L 204/01 (10 Nov. 2001); Council Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE) OJ L 207/03 (18 Aug. 2003); Council Regulation (EEC) No 2137/85 of 25 July 1985 on the EEIG, OJ L 199/1 (31 July 1985).

[101] Unlike the OECD linking rules, the proposed coordination in the home state pays attention exclusively to the tax characterization of the entity under analysis in the state where it is formally and legally organized. Therefore, although contingent in such a way, it avoids the sequential mechanism of primary response and defensive rule, which provides for an extreme dependency on foreign law. For that reason, it is also clear that complexity is reduced, as tax administrations should pay attention only to the tax treatment of the entity where it is organized – a very clear issue when the test is applied to domestic entities – avoiding the complexities in determining whether the payments involved in the transaction where included as ordinary income or whether a proper deduction was granted. Parada, *supra* n. 3, at 363–364. *See also* s. 4.2.3.

[102] This analysis certainly exceeds the purpose of this article. However, this author recognizes that granting supremacy to the tax characterization rules in the home state might create a wrong incentive to incorporate or to establish entities in specific jurisdictions whose tax treatment might be considered in advance as desirable, ultimately creating new tax planning opportunities. For further analysis, *see* s. 4.2.3.

[103] This is true only to the extent the rule is implemented worldwide and room is not left for gaps. *See* Parada, *supra* n. 3, at 397. *See also* s. 4.2.3.

[104] *See* s. 2, Hypothesis 3. However, it is evident that effective taxation will ultimately depend of the total amount of income and expenses at the level of BSub in State *B* (Scenarios 2 and 3) or the total amount of income and expenses at the level of ACo in State *A* (Scenario 1). Therefore, strictly speaking, neither this coordination rules nor the OECD linking rules can appropriately guarantee 'effective' single taxation, but rather only the inclusion of the deductible interest payments in at least one state, which is arguably a synonym for single effective taxation.

Yet, *Scenario 2* can still bring new potential double taxation issues. Indeed, although the interest payments from State *X* (the source state) are recognized as ordinary income in State *B*, nothing prevents State *A* from also applying its CFC rules and exercising its taxing rights on those interest payments. However, as emphasized already in this article, this issue is more hypothetical than practical, as countries around the world normally provide double taxation relief in such situations.[105]

3.3.2.2 Cases Involving Reverse Hybrid Entities

Granting supremacy to the tax characterization rules in the home state means that in the case of reverse hybrid entities receiving deductible payments, those payments will be recognized as ordinary income in the state of the investor without the need to rely on CFC rules.[106]

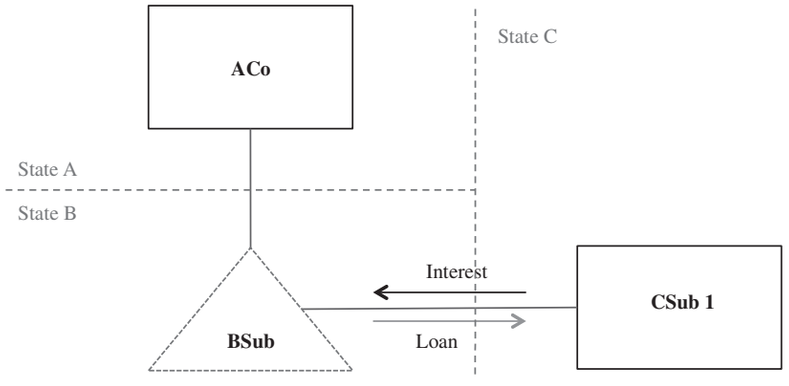
Consider the following simple triangular example. BSub is a tax transparent entity established in State *B* and wholly owned by a company (ACo) established in State *A*. Accordingly, BSub has a subsidiary in a third State *C* (CSub1) from which it receives deductible interest payments. While BSub is indeed a tax transparent entity in its state of establishment (State *B*), State *A* (and State *C*) regard BSub as a taxable entity.

A coordination rule granting supremacy to the tax characterization rules in the home state will imply that BSub is regarded as a tax transparent entity in States *A* and *C*, as well. Therefore, the hybrid entity mismatch disappears and the reliance on CFC rules to solve the mismatch in tax outcomes will become unnecessary. Indeed, ACo will recognize the deductible interest payments as ordinary income in State *A* due to the tax transparency treatment of BSub. This should also satisfy those who argue for ensuring single taxation in cases involving reverse hybrid entities,[107] and proves again that coordination can also be very effective in achieving a single tax result.[108]

Nonetheless, granting supremacy to the tax characterization rules in the home state might raise some concerns in cases where a reverse hybrid entity makes deductible payments either to a third-state entity or to the state of the investors controlling the recipient entity. Consider the facts of Figure 18, with the only difference that a deductible payment of interest is made from BSub to CSub1.

If a coordination rule granting supremacy to the tax characterization rules in the home state (State *B*) is applied, BSub will be regarded as a tax transparent entity in States *A* and *C*, as well. This will generate a deduction in State *A* which would not exist in absence of the application of this rule. In other words, without this coordination rule in the home country, State *A* would regard BSub as a taxable entity and no deduction for the interest paid would be allowed. However, the coordination under the tax characterization rules in State *B* will generate a benefit (deduction) for ACo which would not

Figure 18 Coordination in the Home State and Deductible Payments Received by Reverse Hybrid Entities



Coordination in the 'home state' means that BSsub will be regarded as a tax transparent entity in State A and in State C as well. The rule solves thus the hybrid entity mismatch without need of relying on CFC legislation in State A.

Notes

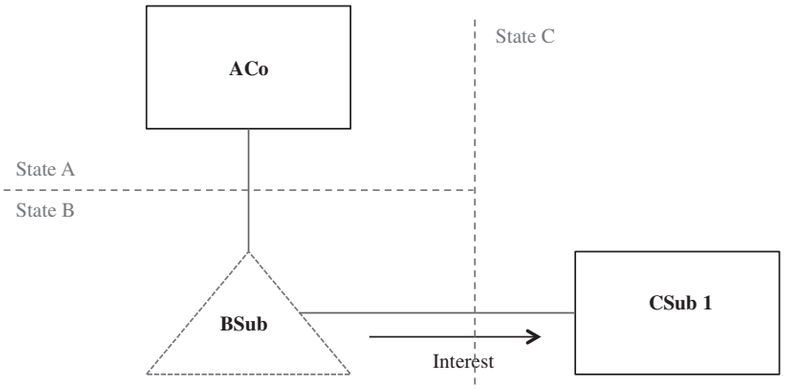
[105] E.g. *supra* n. 14 & *supra* n. 104.

[106] This is indeed the same outcome that 'coordination at source' arrives at when a third source state (in a similar triangular situation) regards the entity (BSub) as tax transparent. *See supra* Figure 5.

[107] However, the single taxation outcome is true only to the extent that ACo has a positive taxable income for that taxable year.

[108] This author has already raised some concerns as regards ensuring effective single taxation. *See* e.g. *supra* n. 13 and 104.

Figure 19 Coordination in the Home State and Deductible Payments Made by a Reverse Hybrid Entity to a Third Country



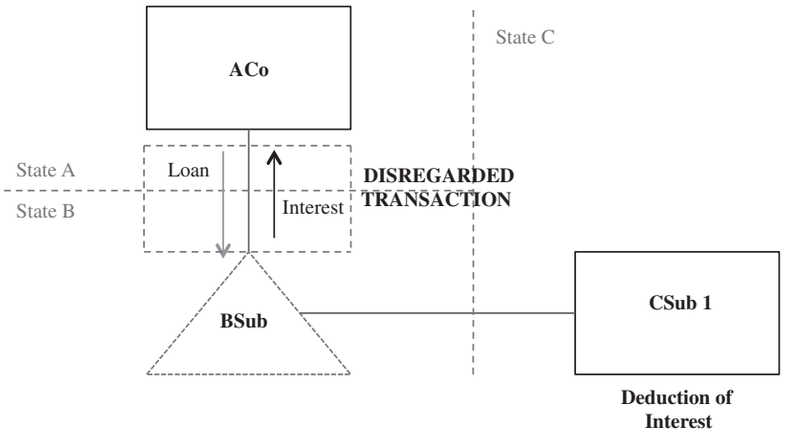
A 'switch-off' of the coordination rule might be applied in this case. The above should be perfectly acceptable since the outcome of this triangular transaction was not seen as problematic before the application of this coordination rule.

exist otherwise. This might be considered unfair. This is the reason why the original proposal for a coordination rule granting supremacy to the tax characterization rules in the home state contemplates the possibility to 'switch-off' (disapply) the rule in these cases.[109] This means that the coordination rule could be suspended for these triangular cases where a reverse hybrid is making a payment to a party in a third country.[110]

Similarly, a coordination rule granting supremacy to the tax characterization rules in the home state might also raise concerns in cases where a reverse hybrid entity is making a deductible payment to a party in the country of the investors controlling the recipient entity. In these cases, and by the sole application of the coordination rule, the loan transaction will be disregarded for tax purposes. In other words, a tax benefit will arise only by granting supremacy to the tax characterization rules in the home state.

This can be illustrated by using the same facts in Figure 18, with the only difference that BSub makes deductible interest payments to ACo.

Figure 20 Coordination in the Home State and Payments Made by a Reverse Hybrid Entity to Its Controlling Investor



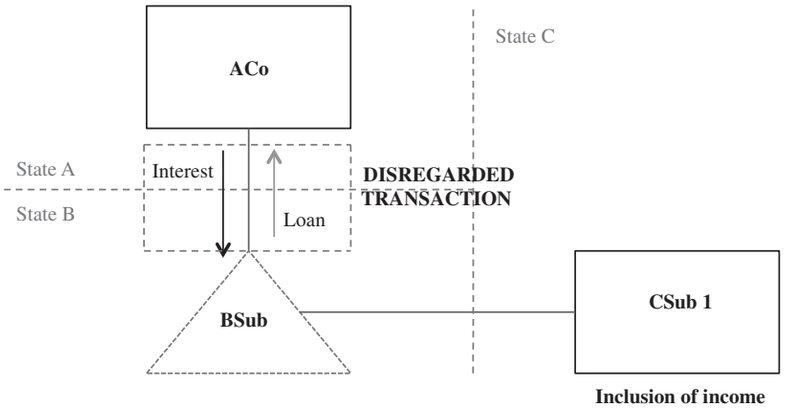
BSub will be considered as tax transparent entity in State A, State B (home state) and State C. This means that the loan transaction between ACo and BSub will be completely disregarded for tax purposes. In addition, a deduction can be generated in State C.

Notes

[109] Parada, *supra* n. 3, at 365–368.

[110] The switching-off does not require further elaboration, as it implies merely that countries including the 'reactive coordination rule' (coordination in the home state) might opt not to apply the rule in this particular triangular case, namely where a hybrid entity makes a payment to a third state. Introducing a specific exception under domestic law could do this. Parada, *supra* n. 3, at 367.

Figure 21 Coordination in the Home State and Deductible Payments Received by a Reverse Hybrid Entity from Its Investors



BSub will be considered as tax transparent entity in State A, State B (home state) and State C. This means that the loan transaction between ACo and BSub will be still disregarded for tax purposes. In addition, the interest payments will be recognized as ordinary income in State C.

If a coordination rule granting supremacy to the tax characterization rules in the home state applies, BSub will be regarded as a tax transparent entity not only in State *B* (the home state), but also in State *A* and State *C*. That is, the loan transaction between ACo and BSub will be completely disregarded for tax purposes, i.e. no interest deduction will be allowed in State *B*, nor will there be an inclusion of income in State *A*. Moreover, a deduction in State *C* might arise now that State *C* also regards BSub as a tax transparent entity. All of these outcomes are the exclusive result of the application of this coordination rule, which might still raise some concerns. For this purpose, the original proposal for a coordination rule granting supremacy to the tax characterization rules in the home state contemplated the possibility to switch off the rule in cases where the sole application of the rule would grant some tax benefits that did not exist in absence of the rule.[111] However, the possibility to switch off the rule should, in any case, be interpreted as either a contradiction or a defect of the proposed coordination rule.[112]

Finally, taking the example in Figure 20, but with the sole difference that ACo pays interest to BSub, a coordination rule granting supremacy to the tax characterization rules in the home state could also achieve a positive result. First, the hybrid entity mismatch is eliminated. Second, the outcome – for those concerned with single taxation – will be a non-deduction/inclusion, i.e. the loan transaction between ACo and BSub is disregarded for tax purposes (non-deduction),[113] as the interest income will be recognized as such in State *C*.[114]

3.3.3 *Practical Examples in Support of This Proposal*

Some examples of granting supremacy to the tax characterization rules in the home state can be found as an interpretation of the Spanish tax characterization rules, as well as in the EU Common Consolidated Tax Base (CCTB) Proposal.[115] Both cases are briefly referred to below, although without the intention of providing an in-depth analysis, but rather merely to offer an insight that allows the author to support the hypothetical analysis already carried out in section 3.3.2.

3.3.3.1 Article 62(1) of the EU CCTB Proposal

Article 62(1) of the EU CCTB Proposal is a noteworthy example to support the idea of a coordination rule

Notes

[111] Parada, *supra* n. 3, at 368–369.

[112] *Ibid.*

[113] This does not mean that a deduction is disallowed, but rather that there will be no deduction possible, because the transaction is not recognized for tax purposes.

[114] However, this does not ensure taxation in State *C*. Indeed, if CSub1 has more expenses than income for that taxable year, there will be no payment of taxes. Similarly, if the corporate income tax rate in State *C* is 0.01%, an economic result similar to non-taxation will be achieved. This demonstrates again the inconsistent idea behind single taxation. For a further critique of single taxation and the concept of double non-taxation, *see* Parada, *supra* n. 3, at 13–51. Also on the topic of double non-taxation, *see* Marchgraber, *supra* n. 3.

[115] For an explanation of the Spanish rule as regards the tax characterization of entities for tax purposes, *see* s. 3.1.3.2.

granting supremacy to the tax characterization rules in the home state as a suitable proposal to replace the current OECD linking rules. According to Article 62(1) of the CCTB Proposal: 'Where an entity is treated as tax transparent in the Member State where it is established, a taxpayer holding an interest in the entity shall include its share in the income of the entity in its tax base'.[116] Therefore, a taxpayer holding an interest in a tax transparent entity established in a Member State must follow the tax treatment given to it in the Member State where the entity is established, which is indeed a coordination rule.[117]

The proposed provision appears to apply indistinctly to all partners of a partnership established within any EU Member State, regardless of their percentage of ownership. This certainly simplifies its application and brings the provision closer to the author's proposal in section 3.3.2. Accordingly, as no distinction is made as regards cases involving non-EU taxpayers holding an interest in EU tax transparent entities, one could conclude that the rule is not exclusively applicable to intra-EU hybrid entity mismatches. Such an interpretation should indeed be desirable, as the effectiveness of a coordination rule relies exclusively on its extended scope. However, the limited definition of 'taxpayer' in the CCTB Proposal causes this author to conclude that Article 62 was conceived to be applied exclusively in cases of intra-EU hybrid entity mismatches.[118] However, Article 62 appears not to be applicable to reverse situations, i.e. cases when a Member State – where the entity is established – treats such an entity as tax opaque, while the state of the taxpayer holding an ownership interest in that entity treats it as tax transparent. That is, cases of hybrid entities. This clearly demonstrates that the ultimate aim of the provision is to cover situations involving reverse hybrid entities, although under a different approach in comparison with other existing EU law provisions.[119]

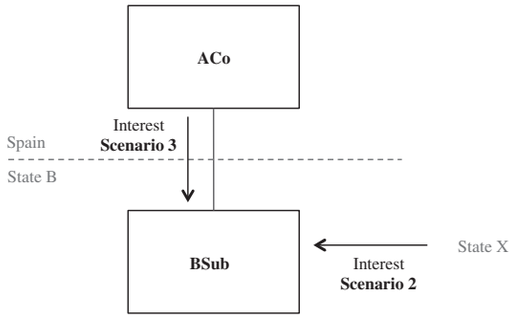
Finally, the path of coordination offered in Article 62 of the CCTB Proposal differs from the solution in Article 63 of the CCTB Proposal as regards third states. Article 63 of the CCTB Proposal states: 'The question whether an entity that is located in a third country is transparent or not shall be determined *according to the law of the Member State of the taxpayer*' (emphasis added).[120] Therefore, although this provision could, in principle, be interpreted as a rule that grants priority to the characterization rules in the Member States where the investors are located, or – more precisely – where they are tax residents, in the author's opinion it is not properly a coordination rule. Therefore, if Article 63 of the CCTB Proposal is applied, it will still generate cases of hybrids and reverse hybrid entities.

3.3.3.2 Spanish Coordination Practice: Other Hybrid Entity Mismatches

As already emphasized in section 3.1.3.2, the Spanish administrative interpretation of its domestic tax characterization rules resembles a coordination rule.[121] This coordination appears to grant supremacy to the tax characterization of the source state in all those cases where a foreign hybrid entity makes a payment to its Spanish investors.[122] Nonetheless, in all other cases (e.g. when Spanish investors controlling a foreign hybrid entity make deductible payments to it or when a foreign hybrid entity or a reverse foreign hybrid receives deductible payments from a party in a third state in a triangular case), the Spanish authoritative interpretation comes closer to a coordination rule granting supremacy to tax characterization rules in the home state of the relevant entity.

The latter situation can be illustrated using the facts in Figure 17 as regards Scenario 2 and Scenario 3 referred to hybrid entities.[123] For this purpose, simply assume that State *A* is Spain and, therefore, ACo is a Spanish company. All the other facts remain the same.

Figure 22 Spanish Administrative Practice and Hybrid Entities



Notes

[116] European Commission, *Proposal for a Council Directive on a Common Corporate Tax Base*, COM (2016) 685 final, (25 Oct. 2016), Art. 62(1).

[117] For a general analysis of the CCTB, *see* D. Gutmann & E. Raingeard de la Blétière, *CC(C)TB and International Taxation*, 26 EC Tax Rev. 5 (2017).

[118] European Commission, *supra* n. 116, Art. 4(1) – Definition of resident.

[119] E.g. Art. 9a ATAD 2 (analysed at s. 3.2.3.3).

[120] European Commission, *supra* n. 116, Art. 63.

[121] Taking a similar position, *see* Jiménez-Valladolid de L'Hotellerie-Fallois & Vega Borrego, *supra* n. 46. *See also* Mosquera Mouriño, *supra* n. 46; Parada, *supra* n. 3, at 157–162.

[122] *See* s. 3.1.3.2.

[123] *See* s. 3.3.2.1.

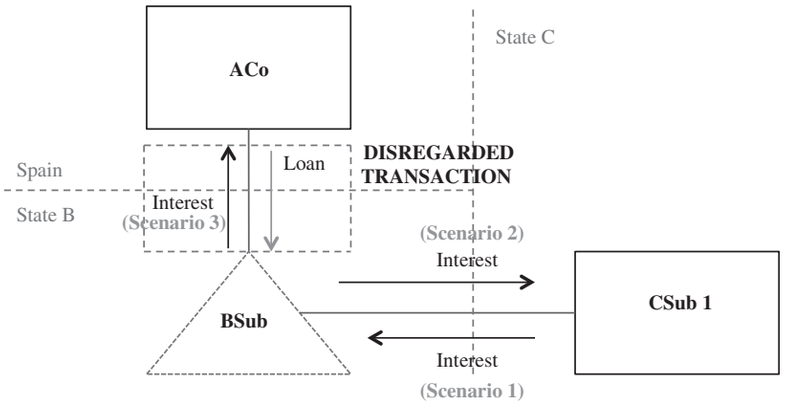
In both scenarios Spain will follow the tax characterization of BSub in State *B* (i.e. the home state). Therefore, if ACo (a Spanish company) makes a deductible payment of interest to BSub, the tax treatment of BSub as a taxable entity in State *B* will be followed by Spain. That is, Spain will indeed regard BSub as a taxable entity. This means not only that the hybrid entity mismatch will completely disappear, but also that the outcome of the hybrid transaction will be a deduction/inclusion of income, which should also satisfy those concerned with single taxation.[124] Similarly, when BSub receives deductible payments from a party in a third state, Spain will regard BSub (i.e. the recipient) as a taxable entity. In other words, no hybrid entity mismatch will arise and the outcome of the transaction should again leave sceptics and non-sceptics of single taxation equally satisfied.[125] This results resemble Scenarios 2 and 3 in section 3.3.2.1.

The cases involving reverse hybrid entities are illustrated below considering three scenarios: (1) deductible interest payments received by a reverse hybrid entity, (2) deductible interest payments made by a reverse hybrid entity (controlled by a Spanish investors) to a party in a third state and (3) deductible interest payments made by a reverse hybrid entity to its Spanish owner, which controls the payee entity.

As to Scenario 1, the effect of the Spanish administrative practice is precisely that illustrated in Figure 18. That is, BSub will be regarded as a tax transparent entity in Spain and State *C*, and reliance on CFC rules to counteract the hybrid entity mismatch will become unnecessary, as the interest payments will flow through BSub until the sole owner in State *A* (ACo). This could also ensure that the interest payments are recognized as income in one state, which proves again that coordination can also be very effective in achieving a single tax result.[126] Similarly, in Scenario 2, the effect of the Spanish administrative practice is precisely that illustrated in Figure 19, that is, BSub will be regarded as a tax transparent entity in Spain and State *C*. Therefore, a deduction for the interest payments will be allowed in Spain, while such interest will be recognized as income in State *C*.[127] Finally, in Scenario 3, the outcome of the Spanish administrative practice will be very similar to that illustrated in Figure 20, that is, BSub will be regarded as tax transparent entity in Spain and in State *B*. Therefore, the hybrid entity mismatch disappears. Accordingly, the entire loan transaction between ACo and BSub will be disregarded for tax purposes.

As a result, therefore, one could conclude that the Spanish approach eliminates the possibilities for mismatches as regards the tax characterization of a relevant foreign entity ('foreign' from a Spanish perspective). However, it still leaves open possibilities for mismatches when Spanish entities are characterized in a different manner by a foreign state. Such an outcome could nonetheless be avoided if a similar coordination rule were to be applied worldwide, which is indeed the ultimate aim of this proposal for coordination.[128]

Figure 23 Spanish Administrative Practice and Reverse Hybrid Entities



Notes

[124] Even though this author has already argued that 'effective single taxation' cannot be ensured, because it ultimately depends of the levels of income and expenses of BSub. *See* e.g. *supra* n. 13 & 104.

[125] However, effective single taxation in this case will again depend on the level of income and expenses of ACo. *See* e.g. *supra* n. 13 & 104.

[126] However, this author has also emphasized some concerns as regards ensuring 'effective single taxation, which will ultimately depend on the level of income and expenses of ACo in State *A*. *See* e.g. *supra* n. 104.

[127] The author still assumes the same facts of Figure 19, i.e. CSub1 is a taxable entity in State *C*. Otherwise, it is evident that income will be recognized at the level of its partners either in State *C* or elsewhere, depending on whether these are legal entities (taxable or transparent) or individuals.

[128] Parada, *supra* n. 3, at 162.

4 Implementation and other issues

This section, which stresses some implementation and other issues regarding the proposals explored above, is divided into two parts. The first part reinforces the idea that only a uniform and worldwide implementation of a coordination rule – granting supremacy to the tax characterization in either the source state, the residence state or home state – could ensure true success. Likewise, it argues that only one of these single proposals could be implemented worldwide in order to ensure that complexity and transaction costs are indeed reduced. The second part of this section turns the analysis of some specific open questions as regards each of the proposals analysed so far.

4.1 *Uniform and Worldwide Implementation*

As already emphasized, the alternatives analysed in this article have been presented in a neutral way, i.e. without necessarily disclosing the preferences of the author for one or another. Accordingly, they share the common characteristic of being exclusive. That is, only one of them should ultimately and uniformly be implemented worldwide. This is particularly critical if complexity and transaction costs are to be reduced under any of these alternatives.[129]

As to the implementation itself, in the author's opinion, the only possible way to guarantee a successful worldwide implementation of a coordination rule – any of those proposed here – would be through recommendations, i.e. in a very similar way as the OECD linking rules were promoted. However, this is not an easy task, especially because it demands a complete switch in the way hybrid entity mismatches are understood.[130] Indeed, as has been widely analysed elsewhere, the OECD approach to issues concerning hybrid and reverse hybrid entities follows a path that is entirely different from that of coordination.[131] This approach, which has been criticized for being too consequentialist,[132] starts from the basis of recommending domestic rules that are based on linking the tax outcomes resulting from hybrid entity transactions.[133] In particular, the OECD domestic recommendations view economic double non-taxation as the core of the problem regarding hybrid entity mismatches. Such an approach relegates the tax characterization of entities, i.e. the true reason for the existence of hybrid and reverse hybrid entities, to the metaphorical backyard.[134] Therefore, a recommendation that would start from the basis of coordination must have, at a minimum, the support of the OECD members, which appears to be, in principle, an impossible task.

Another means of implementing any of these alternatives could be through the use of supranational law that would affect a wide group of countries, e.g. the European Union. This idea is neither novel nor the sole province of this author, and has already been extensively analysed.[135] However, the author is rather pessimistic as regards its potential impact. First, the limited regional scope of such a proposal is rather evident and could not ensure a global solution.[136] Second, the European Commission has unfortunately demonstrated in the past that by even having the chance to deviate from the OECD linking rules, adopting perhaps a more fundamental approach as regards hybrid entity mismatches, it has finally succumbed to political pressure.[137] This is also a demonstration of the true role played by the OECD in matters concerning international coordination, especially when such an idea has originated from within the OECD.

4.2 *Open Questions as Regards the Proposals*

Despite the fact that coordination offers a very positive perspective in order to deal with hybrid entity mismatches, not all is a bed of roses. All three alternatives analysed in this article still leave open questions as regards their separate implementation and efficacy. These questions are analysed below.

Notes

[129] The high level of complexity and transaction costs is a sound critique as regards the OECD linking rules. However, this critique could also be extended to these proposals for coordination if they are all implemented at once and as three alternatives that countries might opt for. Such an idea would scarcely contribute to simplicity and ease of administration, ultimately elevating the transaction costs for both taxpayers and tax administrations. For a critique of the OECD linking rules, *see* Parada, *supra* n. 1.

[130] OECD, *Action 2: 2015 Final Report, supra* n. 2.

[131] E.g. Parada, *supra* n. 1. *See also* Parada, *supra* n. 3, at 277–352.

[132] Parada, *supra* n. 1.

[133] Although not strictly analysed in this article because of the nature of domestic recommendations, the OECD proposes the implementation of domestic rules that primarily deny a deduction if the relevant income is not included as ordinary income in the hands of the recipient in the other country, i.e. a 'primary response', or tax the income that was not taxed in the hand of the recipient originally, i.e. a 'defensive rule'. These rules are presented to the public as linking rules. OECD, *Action 2: 2015 Final Report, supra* n. 2, at 49–66.

[134] Parada, *supra* n. 3.

[135] Fibbe, *supra* n. 4, at 293–384.

[136] For some attempts at coordination of the tax characterization of entities in the European Union, *see* Art. 10(1) of the Proposal for ATAD, *supra* n. 30. For an analysis of this provision, *see* s. 3.1.3.1. *See also* more recently, Art. 9a ATAD 2 (reverse hybrid entities), *supra* n. 89. For an analysis of this provision, *see* s. 3.2.3.3.

[137] This is evident in the final adoption of linking rules in the ATAD 1. *See* European Commission, *supra* n. 31, Art. 9. Taking a similar position, *see also* Fibbe & Stevens, *supra* n. 36.

4.2.1 *Supremacy of the Tax Characterization Rules of the Source State*

There are three significant open questions as regards the worldwide application of a rule granting supremacy to the tax characterization rules of the source state.

First, there is a question concerning the determination of the 'source state'. At first glance, the rule appears to be easy to apply. However, the determination of the source of income is not always an easy task and in some cases could result in multiple sources.[138] A reasonable question in this regard therefore concerns which source state should be considered for purposes of the coordination rule. This could certainly relativize the positive impact of this proposal.

Second, an important question concerns the implicit 'coherence' underlying hybrid entity mismatches and the application of a coordination rule granting supremacy to the tax characterization of entities at source.[139] Indeed, one could argue that it is the country which creates the mismatch that is the first one called to react in case of a hybrid entity mismatch.[140] That is, it would be the country the tax characterization rules of which differ from those where the entity is established which should indeed react.[141] Such an idea might coincide when a hybrid entity makes a payment to its investors abroad, i.e. the source state and entity's establishment country would coincide in such a case.[142] However, in all other cases, i.e. when investors makes deductible payments to a hybrid entity abroad, or when a hybrid entity or a reverse hybrid receives deductible payments from a party in a third country in a triangular case, the source state and the state of establishment of the relevant entity will not coincide.[143] This would imply that following an approach which grants supremacy to the tax characterization rules in the source state would not necessarily be 'coherent' with the fact of placing the burden of reaction on the country generating the mismatch.[144] Yet, this idea could be argued against if hybrid entity mismatches are understood as a simple and inevitable consequence of the autonomous tax characterization rules applied by countries around the world.[145] This idea is not wrong. However, it places the issue of hybrid entity mismatches in a permanent state of inertia.[146] That is, no country should react to the disparities and everyone should simply accept them as a sunk cost of cross-border activities.[147]

Third, a rule granting supremacy to the tax characterization rules in the source state could also raise questions as regards legal certainty, especially in those cases involving a reverse hybrid entity receiving a payment from a party in a third state different from the investors' state and from the entity's state of establishment.[148] For example assumes that a coordination rule granting supremacy to the tax characterization rules of the source state is applied and that a deductible payment is made from a party in a third state to a reverse hybrid located in another state and controlled by another entity in a different state, too.[149] As the source state will never coincide with the state from which the entity is formally or legally established, i.e. supremacy to the tax characterization rules of the source state will always imply that the tax characterization of the relevant third (source) country will prevail. Such a result might be questionable from a legal certainty perspective, especially because the rule will be triggered only when the owners abroad treat the tax transparent entity as a taxable one, which might leave investors in an uncertain position when they decide to carry out business

Notes

[138] The issues regarding the determination of source have been largely discussed in literature. *See* e.g. L. Lokken, *What Is This Thing Called Source?*, 37(3) Int'l Tax J. 21–26 (2011). *See also* F. Vanistendael, *Reinventing Source Taxation*, 6(3) EC Tax Rev. 152–161 (1997). For a tax treaty approach as regards issues on source, *see* J. Avery Jones et al., *Tax Treaty Problems Relating to Source*, Brit. Tax Rev. 3 (1998).

[139] 'Coherence' is indeed the core of Action 2. As stated by the OECD: 'The recommendations set out in this report are intended to operate as a *comprehensive* and *coherent* package of measures to neutralize mismatches that arise from the use of hybrid instruments and entities without imposing undue burdens on taxpayers and tax administrations' (emphasis added). OECD, *Action 2: 2015 Final Report, supra* n. 2, at 94.

[140] Lüdicke, *supra* n. 1, at 317.

[141] Parada, *supra* n. 3, at 359.

[142] *Ibid.*, at 356–357.

[143] *Ibid.*

[144] *Ibid.*, at 360.

[145] Explaining the rather unclear concept of 'tax arbitrage', Rosenbloom argues that taxpayers can legitimately arrange their affairs in order to achieve double non-taxation and using for this purpose uncoordinated tax rules among jurisdictions. Rosenbloom, *supra* n. 5, at 116. Also taking the same position, *see* Kane, *supra* n. 5, at 89. *See also* T. Edgar, *Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage*, 51 Can. Tax J. 3 (2003); D. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44(1) B. C. L. Rev. (2002); J. Roin, *Taxation without Coordination*, 31 J. Legal Stud. 1, Part 2 (2002); T. Gresik, *The Taxing Task of Taxing Transnationals*, 39(3) J. Econ. Lit. (2001). In contrast, *see* Dell'Anese, *supra* n. 5. *See also* R. Avi-Yonah, *Tax Competition, Tax Arbitrage and the International Tax Regime*, 61(4) Bull. Int'l Tax'n (2007); T. Rosembuj, *International Tax Arbitrage*, 39(4) Intertax (2011); J. Prebble, *Exploiting Form in Avoidance by International Tax Arbitrage: Arguments Towards a Unifying Hypothesis of Taxation Law*, 17(1) Asia-Pac. Tax Bull. (2011).

[146] As argued by Cooper: 'The problem is that the driving force which generates hybrids, i.e. inconsistent policy choices made by national governments, is almost ubiquitous'. Cooper, *supra* n. 1, at 334.

[147] In contrast, this article starts from the hypothesis that a reaction is needed. However, this should start from properly distinguishing the problems. *See* s. 2, Hypothesis 2.

[148] *See* ss 3.1.2.1 & 3.1.2.2.

[149] *See* s. 3.1.2.2, Figures 4 and 5.

through a tax transparent entity rather than a corporation.[150]

4.2.2 *Supremacy of the Tax Characterization Rules of the Residence State*

The option to grant supremacy to the tax characterization rules in the residence state of the majority of the owners of a relevant entity is not completely without its flaws, either. Indeed, it still raises critical questions as regards legal certainty, especially with respect to the treatment of minority shareholders (owners).

The proposed wording of the rule starts from the basis that the state of establishment of the relevant entity should align its tax characterization with that granted in the country where '[…] more than 50% of its owners – directly or indirectly by shares or voting rights – are tax residents […]'.[151] This recharacterization for tax purposes of the entity in the country where it is established, triggered in particular by the percentage of ownership held in that entity (more than 50%) could raise reasonable questions as regards legal certainty, especially by those who are not part of the 50%.[152] This question has already been raised as regards similar rules used to support this proposal, such as the anti-hybrid rules in Denmark, where it is clear that the rule equally affects all shareholders once an entity has been recharacterized as a taxable entity.[153] If the proposed rule is therefore interpreted in the same direction, it would appear to be disproportionate and disadvantageous for the interests of minority shareholders, and it could give rise to significant internal conflicts and negative consequences for the normal functioning of a business.[154] In the worst case scenario, it could influence the decisions of domestic investors to carry out business based on the residents of the foreign investors and the tax treatment granted to the entity in their country.[155] This result would not only be absurd, but could also generate important barriers for the economic development of a state.[156] A different approach could be that followed by Recommendation 5.2 of the OECD BEPS Action 2 Final Report, which provides a similar rule, although without making any reference to percentages of ownership in the relevant entity.[157] Such an approach, however, will turn over the argument of certainty now as regards the majority being subject to the tax characterization of the entity triggered by a minority of shareholders.[158]

Other still raising questions as regards this proposal refers to the legal effect once the recharacterization is triggered.[159] For example would the normal rule that the owner of a fiscally transparent entity is deemed to own also a proportionate part of the entity's assets and liabilities, not be applicable after the recharacterization? In other words, would the recharacterization imply that the owners are deemed to have an ownership in a separate entity? If that is the case, any disposal of an interest in the relevant entity would be regarded as a 'sale of shares', the capital gains from which might not necessarily be taxed in the hands of non-residents.[160] Accordingly, a rollover principle at the level of the owners of the entity should be considered in order to ensure that the owners are generally not taxed on any gains on the assets held by the entity as a consequence of the recharacterization.[161] That is, the owners of the recharacterized entity should be deemed to have acquired their ownership interest in the entity at a price equal to the tax value of the assets and liabilities held by the entity at the time of the recharacterization. Moreover, assets and liabilities held by an entity that is recharacterized should be regarded as having been acquired at the same time that the owner acquired them and at a similar price, i.e. a rollover principle at the entity level.[162]

Finally, some questions could still arise as regards dividend distributions from the recharacterized entity and the potential application of withholding taxes in the state where the recharacterized entity is establish. Indeed, if the tax transparent entity is now regarded as a taxable entity, the distribution of profits made to non-residents

Notes

[150] *Ibid.*

[151] *See* s. 3.2.1.

[152] Although beyond the scope of this article, it could also raise questions at the level of tax treaties, especially as regards Art. 24(5) of the OECD Model.

[153] Møllin Ottosen & Nørremark, *supra* n. 61, at 514. For an analysis, *see also* Parada, *supra* n. 3, at 171–172.

[154] Parada, *supra* n. 3, at 170 (Figure 19).

[155] *Ibid.*, at 171.

[156] *Ibid.*

[157] OECD, *Action 2: 2015 Final Report, supra* n. 2, at 64–65.

[158] *See* s. 3.2.3.2.

[159] Some of these concerns are also emphasized as regards the Danish rules. Møllin Ottosen & Nørremark, *supra* n. 61, at 514–515.

[160] This is particularly true in the case of two states having a tax treaty and applying Art. 13(5) of the OECD Model to the 'sale of shares', as taxing rights are allocated exclusively to the residence state.

[161] Møllin Ottosen & Nørremark, *supra* n. 61, at 514–515 (as regards the Danish anti-hybrid rules).

[162] *Ibid.*

should, in principle, be subject to withholding taxes.[163] If no distribution takes place, concerns might still arise as regards the application of CFC rules in the state of the investors, as the entity could now qualify as a CFC.[164] In the author's opinion, unless a specific exception applies, both withholding taxes and CFC rules should affect the distributed and undistributed profits, respectively.

4.2.3 *Supremacy of the Tax Characterization Rules of the Home State*

Unlike the other two proposals, a rule granting supremacy to the tax characterization in the home state of the relevant entity, i.e. where the entity is legally and formally organized, do not raise issues as regards either legal certainty or the determination of the source of the income.[165] However, such a rule still possesses an inherent disadvantage, namely the potential for a cherry-picking effect.

The proposal calls for aligning the tax characterization of an entity according to that given in the entity's country of establishment. This could create an inappropriate incentive to set up entities in a state where the tax treatment is more favourable from a tax planning perspective, ultimately incentivizing jurisdictional cherry-picking and bringing with it the incentive for countries to take steps to attract certain business structures. Nevertheless, this is not entirely true. For example in all those cases where a hybrid entity is involved, either receiving or making deductible payments, a coordination rule granting supremacy to the tax characterization rules in the home state would imply that all countries involved will treat the relevant entity as a taxable entity.[166] Therefore, those payments will be recognized as income somewhere, independently of whether effective taxation ultimately applies.[167] This can be clearly seen in Figure 17, where the hybrid entity mismatch disappears after the application of the coordination rule, achieving also the outcome pursued by BEPS Action 2.[168] In this scenario, therefore, it is difficult to conclude that cherry picking will truly be a problem in practice.

A similar conclusion can be reached in the case of reverse hybrid entities receiving a payment from a party in a third country, such as the case illustrated in Figure 18.[169] In this case, the application of a coordination rule granting supremacy to the tax characterization rules in the home state would imply that the hybrid entity mismatch will disappear, i.e. the relevant entity is now a tax transparent entity in the eyes of the three states involved and the reliance on CFC rules to solve the mismatch becomes unnecessary. The outcomes will also be aligned, as the country of the investors will be able to recognize the income received by the tax transparent entity (no longer a reverse hybrid), independently of course of whether effective taxation ultimately applies in that state.[170] Likewise, as demonstrated in Figure 21, the mismatch is eliminated and the outcomes are also aligned, allowing the recognition of income received by the tax transparent entity.[171] Therefore, and once again, the risk of cherry picking in those cases should not represent a true concern in practice, especially because the outcomes achieved after the application of the rule would be a disincentive to such conduct.

However, a different conclusion can be reached in the cases involving reverse hybrid entities, especially when a reverse hybrid entity makes a deductible payment either to a third-country entity or to the country of the investors. As noted in Figure 19 and in Figure 20, such situations could create benefits (deductions) that were not available before the application of the coordination rule or they could disregard a transaction not originally disregarded.[172] These outcomes might then wrongly encourage taxpayers towards cherry-picking conduct, which in those situations could be a true concern. This conduct could nonetheless be neutralized if the coordination rule is suspended in all those triangular cases where a reverse hybrid is making a payment to an entity in a third country or to the country of its investors.[173] Such a suspension should, in any case, be interpreted as a

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[163] If a distribution from the recharacterized entity takes place, it should be classified as a dividend, and potentially subject to withholding taxes. This issue is not necessarily a matter of concern in the EU, because of the Parent-Subsidiary Directive. However, other countries outside the EU still apply withholding tax to dividends. Cooper, taking the example of Australia, also stresses this issue. Cooper, *supra* n. 1, at 348.

[164] This could give rise to new situations of double taxation. However, most of them should be easily overcome with proper domestic relief. *See* the example of US domestic tax relief at *supra* n. 14.

[165] Parada, *supra* n. 3, at 353 et seq.

[166] *See* s. 3.3.2.1.

[167] The author has repeatedly argued this. *See* e.g. *supra* n. 104.

[168] *See* s. 3.3.2.1.

[169] *Ibid.*

[170] *Supra* n. 104.

[171] *See* s. 3.3.2.2.

[172] This was originally emphasized by this author. Parada, *supra* n. 3, at 366–368.

[173] The author calls for a switch-off of the rule in s. 3.3.2.2. *See also* Parada, *supra* n. 3, at 367 and 368. For an explanation of the effects of switching-off the rule and the application of tax treaties, *see* Parada *supra* n. 3, at 395–396.

contradiction or as a defect of the proposed coordination rule for those two triangular cases.[174] Moreover, one should also consider that the outcomes of these triangular transactions were not seen as problematic before the application of this proposed coordination rule,[175] which should be a plus for considering the introduction of this exception in order also to control a potential cherry-picking problem. However, and once again, this solution could be effective only to the extent it is applied worldwide.

5. Conclusion

This article has offered a more fundamental approach to hybrid entity mismatches. This approach starts from the basis of refocusing attention exclusively on the disparate tax characterization of entities, disregarding therefore the matching of tax outcomes (in particular the double non-taxation outcome) as the central element in the design of domestic anti-hybrid entity rules. For this purpose, three specific alternatives were explored based on coordination in the tax characterization of entities, and the results are indeed promising.

Granting supremacy to the tax characterization rules in the source state has proven to be a very feasible solution when a hybrid entity makes deductible payments to a related investor or when a reverse hybrid entity receives deductible payments from a party in a third state. However, some questions still arise in the cases where hybrid entities receive payments either from their controlling investors or from a party in a third country, and when reverse hybrid entities make deductible payments either to their controlling investors or to a party in a third country. However, nothing prevents those countries from preventing the application of a coordination rule granting supremacy to the tax characterization rules in the source state in all those specific cases, especially considering that these cases did not generate international concern either pre-BEPS or post-BEPS.

Accordingly, granting supremacy to the tax characterization rules in the residence state also appears to be a very noteworthy solution to cases involving hybrid entities making deductible payments to a related investor or receiving payments from a party in a third state. A concern might nonetheless still be raised in the cases of hybrid entities receiving payments from a related controlling investor, especially due to the non-deduction/non-inclusion outcome. This concern is nonetheless irrelevant from the perspective of the application of a coordination rule, which does not attend to double non-taxation as the central element of its design. Similarly, a positive result could also be achieved in the case of reverse hybrid entities receiving a payment from a party in a third state. In this case, coordination at residence not only solves the hybrid entity mismatch, but also avoids exclusive reliance on CFC rules in the country of the investor in order to ensure the recognition of income. This outcome should thus also satisfy those commentators more inclined in the defense of international single taxation. As to reverse hybrid entity structures, coordination at residence could also be a very positive solution in cases of reverse hybrid entities receiving a payment from a party in a third state different from the state of investors, or making a payment to the state of their investors. Nevertheless, some concerns could still be raised in cases of a reverse hybrid entity making a deductible payment to a third state different from the investors, especially when this third state treats the reverse hybrid as a tax transparent entity. In such a case, some international tax scholars might regard granting supremacy to the tax characterization rules in the residence state with scepticism, as it will generate a non-taxation outcome. However, as emphasized in this article, granting supremacy to the tax characterization rules in the residence state starts from the basis that coordination in the tax characterization of entities (rather than matching tax outcomes) is the central element of the proposal.

Notably, both a coordination rules granting supremacy to the tax characterization rules in the source state and coordination rule granting supremacy to the residence state's tax characterization rules are proven to be effective also in practice.[176]

Separate mention should be made of the proposal to grant supremacy to the tax characterization rules in the home state. This proposal, which was just recently elaborated and presented in literature, appears to be a very attractive and effective option. First, its operational mechanism is very simple and the use of the home state as the 'coordination state' also appears coherently justified, as hybrid entity mismatches are the result of a different characterization of an entity when compared to the characterization given in its country of legal or formal organization, i.e. the home state. Second, the proposal assumes a more honest approach in its scope, as it applies to all those cases where there are disparities between two or more countries with respect to the characterization of the same entity. However, this proposal, like the other two, is not all a bed of roses. Indeed, the proposal still leaves open questions regarding its effectiveness. These questions refer specifically to some undesirable effects

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[174] *See* s. 3.3.2.2.

[175] Both schemes in Figures 19 and 20 in this article do not generate a deduction/non-inclusion outcome. Therefore, the OECD did not consider them problematic at all. The OECD approach to hybrid entity mismatches is indeed 'consequentialist', i.e. it starts from the basis that a hybrid entity structure must generate a determined outcome in order to be counteracted. For a critical view of the OECD approach, *see* Parada, *supra* n. 1. *See also* Cooper, *supra* n. 1 and Lüdicke, *supra* n. 1.

[176] *See* ss 3.1.3 & 3.2.3.

that the application of the rule could generate, particularly potential double taxation issues in the case where a hybrid entity receives a payment, and where a tax benefit is granted or a transaction is disregarded solely because of the application of the rule. Yet, as mentioned throughout this article, a coordinated application of the coordination rule and CFC rules in order to avoid potential double taxation issues involving hybrid entities receiving payments, first; and second, a switch-off of the proposed rule in the case of tax benefits or disregarded transactions resulting exclusively from the application of the rule, could provide a better scenario. Still, a worldwide, consistent and uniform implementation of this rule is crucial to ensure its practical positive impact.

Finally, none of the alternatives analysed in this article has presumed to be presented as perfect solutions, let alone unassailable ones, but rather to serve as a guide to reorientate the debate surrounding hybrid entity mismatches towards what really matters. Indeed, reorganizing one's thoughts on this matter is the first step in order to avoid a consequentialist approach, as regards both the distinction of the problems and the proposals designed to counteract them. As shown here, coordination is a feasible and serious path to consider.