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Hybrid Mismatches: the Anti-Tax Avoidance Directive

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1 - Abstract

The current document will have the aim to analyze study and understand the latest amendments to the ATA Directive, European 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. These latest amendments were introduced in January 2019 with the new European Council Directive (EU) 2017/952 of 29 May 2017 (so-called ATAD 2), which innovated the 2016/1164 Directive. Since the focus of this amendment is the hybrid mismatches and the rules to avoid them, I have made up my mind and decided of going into deep of this matter, and study them.

I have decided to study the phenomenon of hybrid mismatch because I was fascinated by the issue of tax avoidance practiced by large multinational companies that operate, above all, in countries with privileged taxation. This topic, of extreme interest nowadays, presents facets that have attracted me and led me to analyze the phenomenon more closely and more precisely.

I believe that the subject dealt in this thesis goes promptly to describe the concept of tax avoidance and hybrid mismatches which, until now, has always been considered a subject of secondary importance. With a brief but timely study of mine, I will try to highlight the discipline of tax avoidance, focusing on Hybrid Mismatches expressed in the new ATAD 2 directive, in the new Legislative Decree, and in the OECD BEPS Action 2.

I will start with a short description of the BEPS Package and the OECD Actions, continuing with the history of BEPS in the first part and the analysis of the OECD Action 2. Then a center of attention will be on the main differences of Hybrid mismatches through the ATAD Directive.

The focus, then, will be on the concept of Hybrid Mismatches analyzed with ATAD 2 European Council Directive and the Legislative Decree November 29th 2018 n. 142. A deep description and analysis will be given in the central part of the thesis. Already in the ATAD 1 Council Directive (EU) 2016/1164 of 12 July 2016, there was a reference (see Article 9 [1] of

[1] European Directive (EU) 2016/1164 of 12 July 2016, Art. 9, Hybrid Mismatches: "To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such

the same directive) to these practices, but there had been no solutions nor precise explanations that can deal with the above actions. With the drafting and approval of the new ATAD 2 Directive and precisely with the publication of BEPS Action 2, OECD wanted to put an end to these erosive and evasive practices.

The intention, therefore, will be to analyze the changes related to the treatment of hybrid mismatches and to understand why some of their elements and instruments (such as a particular type of hybrid instruments) are not present or not fully studied in the European Directive and in the Legislative Decree November 29th n. 142. This topic, now more than ever, is highly critical as this harmful practice has been used mostly by large multinationals to profit off taxes paid in countries with privileged taxation.

During the analysis of the European Council Directive and the Legislative Decree, I discover that there is no presence of a critical type of financial hybrid instrument. This instrument is the substitute payment. It is, instead, well discussed in the OECD Action 2 2015 Final Report and in the 2017 report. The question that I posed and to which I will try to give an answer at the end of my thesis is: why these instruments are not discussed and reported in the European Directive and in the Italian Legislation? What was the reasons why this element decided not to be implemented in the European Union soil?

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payment has its source. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment".

2. Base Erosion and Profit Shifting (BEPS)

From the seminal work posed by the League of Nations in the 1902s[2], the structure of the tax principles that we know today has grown. These are briefly the principles: residence taxation, permanent establishments, reduced source taxation, credit and exemption methods for relief of still existing double taxation, and the like. In 1998, the Organization for Economic Co-operation and Development (OECD) [3] released a report on harmful tax competition that signaled an important change of focus in international cooperation efforts. The report directly or indirectly raised three distinct problems related to double non-taxation:

- tax evasion;
- tax avoidance;
- tax subsidies and ‘‘substantive’’ tax competition.

On the second strand of the 1998 report, it appeared that the time has come for greater international cooperation in the area of tax avoidance in the form of the OECD's Base Erosion and Profit Shifting (BEPS) project. [4]

There are three distinct, and yes interdependable, core principles established by the BEPS project and considered fundamental for international tax reform:

- the necessity of establishing the international tax regime on a collaborative-based paradigm rather than on a competition-based paradigm;
- the importance of taking a systematic or holistic approach to substantive international tax reform rather than an ad-hoc approach and acknowledging the interdependence of the norms of the international tax regime;
- the inevitability of accepting completely new solutions to problems that could not be resolved by the applicable norms, contrary to the traditional conservatism of the international tax regime. [5]

Coming to present days, the international tax landscape has changed dramatically in recent years. With political support of G20 Leaders, the international community has taken joint

[2] The League of Nations was an international diplomatic group developed after World War I as a way to solve disputes between countries before they erupted into open warfare. A precursor to the United Nations, the League achieved some victories but had a mixed record of success, sometimes putting self-interest before becoming involved with conflict resolution, while also contending with governments that did not recognize its authority. The League effectively ceased operations during World War II.

[3] OECD, Background Brief, Inclusive Framework on BEPS, January 2017.

[4] H.J. Ault, "Some Reflections on the OECD and the Sources of International Tax Principles" in Tax Notes International Vol.70/12 del 17 Giugno 2013, pags. 1195-1196.

[5] Y. Brauner, *"What the BEPS?"* in Florida Tax Review Vol. 16/2014 Fasc. 2, pagg 58-59.

action to increase transparency and exchange of information in tax matters, and to address weaknesses of the international tax system that create opportunities for BEPS project. [6] The OECD, personifying the role of BEPS' project manager, has engaged in the creation of the Actions not only the representatives of different Member States, but also public opinion and economic operators that have actively intervened in the discussion of the drafts gradually presented by the OECD. On numerous occasions, in fact, the input of the stakeholders has been of considerable importance especially in light of the pressing pace of the BEPS Project. [7] The internationally agreed standards of transparency and exchange of information in the tax area have put an end to the era of bank secrecy. [8] With over 130 countries and jurisdictions currently participating, the Global Forum on Transparency and Exchange of Information for Tax Purposes has ensured consistent and effective implementation of international transparency standards since its establishment in 2009.

At the same time, the financial crisis and aggressive tax planning by multinational enterprises (MNEs) have put BEPS high on the political agenda. [9] In fact, the definitive thrust towards the creation of a comprehensive and holistic program, like the BEPS project, derives from the outbreak of the 2007 economic crisis. It had the foreseeable consequence of shaking the minds of public opinion by providing a perception of urgency to the BEPS project and a notable political visibility on the failures of the rules on the taxation of multinational companies that have not been able to adapt to the reality of modern economic-financial contexts. [10]

With a conservatively estimated annual revenue loss of USD 100 to 240 billion, the stakes are high for governments around the world. The impact of BEPS on developing countries, as a percentage of tax revenues, is estimated to be even higher than in developed countries.

In September 2013, the G20 Leaders endorsed the ambitious and comprehensive BEPS Action Plan, [11] developed with OECD members. [12] Based on this Action Plan, the OECD and

[6] Background Brief, Inclusive framework of BEPS, OECD, January 2017.

[7] P. Saint-Amans, R. Russo, "The BEPS Package: Promise Kept" in Bulletin for International Taxation, Vol. 70/2016 Fasc. 4, pag 236.

[8] Background brief, Inclusive Framework on BEPS, OECD January 2017.

[9] Ibidem.

[10] H.J. Ault, W. Schon, S.E. Shay, "Base Erosion and Profit Shifting: a roadmap for reforms" in Bulletin for International Taxation , Volume 68/2014 n.6/7 pag 275 e ss.

[11] Self, H., Addressing base erosion and profit shifting, British tax review. - London. - (2013), no. 2 ; p. 117-122, 2013;

[12] Background Brief, Inclusive framework of BEPS, OECD, January 2017.

G20 countries developed and agreed, on an equal footing, upon a comprehensive package of measures, in just two years. These measures were designed to be implemented domestically and through tax treaty provisions in a coordinated manner, supported by targeted monitoring and strengthened transparency. The concept of the Base Erosion and Profit Shifting is also well studied by the Self H.[13] with a particular focus on the British situation.

This project however was not accepted and well-liked by all the countries. The main reason was attributable to the Organization itself that has shown an ambivalence behavior about its caretaker role. On one hand, the OECD has worked on increasing its power and influence worldwide, primarily through the promotion of standardization and convergence and, on the other hand, it has always been and has viewed itself as the representative of the interests of its members club of the rich countries. Consequently, it perhaps viewed itself unauthorized to consider interests of other countries, at least to the extent they conflict with its members' interests. [14]

To summarize, the BEPS project refers to tax planning strategies that exploit gaps and mismatches in tax rules to shift *"artificial"* profits to low or no-tax locations where there is little or no economic activity. Although some of the schemes used are illegal, most of them are not. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. Moreover, when the taxpayers see multinational corporations legally avoiding income tax, undermine voluntary compliance by all taxpayers. [15] Some scholars however do not blame only multinational corporations. As example A. Contrino in his work [16] explains how the scope of a multinational company should not be considered only the temptation of minimizing the tax burden, but it should focus his attention detecting if these "illegally" operations are set with the only aim of relieving the fiscal burden on the holdings.

2.1 - About BEPS Package

The BEPS package consists of reports on 15 actions, and sets out a variety of measures ranging from new minimum standards to the revision of existing standards. In particular, four

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[13] OECD, Background Brief, Inclusive Framework on BEPS, OECD January 2017.

[14] Y. Brauner, "What the BEPS?" in Florida Tax Review Vol. 16/2014 Fasc. 2, pag. 62.

[15] www.oecd.org

[16] A. Contrino, "BEPS: Is International Tax Planning Over?" in Tax Notes International, Vol. 75/2014 n. 10, pag. 842

minimum standards were agreed to tackle issues in cases no action by some countries or jurisdictions would have created negative spillovers (including adverse impacts of competitiveness) on others. Their consistent implementation will allow countries to protect their taxable base. [17]

Existing standards have also been updated and will be implemented, noting however that not all countries, which have participated in the BEPS Project, have endorsed the underlying standards on tax treaties or transfer pricing. [18]

In other areas, such as recommendations on hybrid mismatch arrangements and best practices on interest deductibility, countries and jurisdictions have agreed on a general tax policy direction. In these areas, domestic rules are expected to converge through the implementation of the common approaches, thereby still enabling further consideration of whether such measures should become minimum standards. Guidance based on best practices will also support governments intending to act in the areas of mandatory disclosure initiatives or controlled foreign company (CFC) legislation. [19]

The BEPS package was agreed and delivered by OECD members and by G20 economies, and subsequently endorsed by the G20 Leaders Summit in Antalya on 15-16 November 2015. [20]
Even though some elements of the BEPS Action Plan are still being finalized, the main tasks relate now to the implementation of the agreed package.

Effective and consistent implementation of the BEPS package requires an inclusive implementation process. First, the implementation of the BEPS package into different tax systems should not result in conflicts between domestic systems. [21] Furthermore, the interpretation of the new standards should not lead to increased disputes. Finally, it is necessary to ensure a leveled playing field among countries and jurisdictions in the fight against tax avoidance.

Jurisdictions identified as relevant to the work of the Global Forum on Transparency and Information Exchange for Tax Purposes (Global Forum) have already been subject to monitoring and peer review of the implementation of the Global Forum's standards on

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[17] Background brief, Inclusive Framework on BEPS, OECD January 2017.

[18] Ibidem.

[19] Ibidem.

[20] See also reference Bloomberg, Base Erosion and Profit Shifting (BEPS) final Action Plan: a collection of in-depth analysis and insight, 2015.

[21] Background brief, Inclusive Framework on BEPS, OECD January 2017.

transparency and the exchange of information for tax purposes. A similar process is being developed for the implementation of the BEPS package. [22]

2.2 - OECD Actions

A brief insight of the BEPS package is listed below and it consists of 13 Actions. The recommendations take the form of new minimum standards, common approaches and guidance. [23,24]

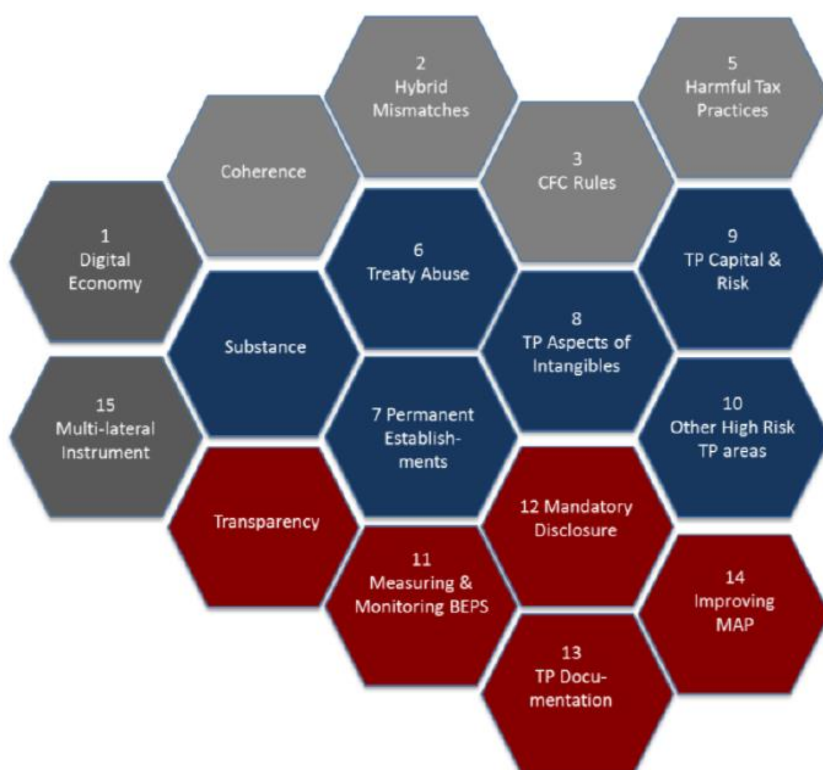

Fig. 1: OECD Action Item of BEPS Project [25]

Action 1

Addresses the tax challenges of the digital economy and identifies the main difficulties that the digital economy poses for the application of existing international tax rules. The Report

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[22] OECD/G20 Base Erosion and Profit Shifting Project, Action 2, 2015 Final Report, Summaries of the Report;

[23] Svasti-Salee, J, Around the world in 13 reports, Tax adviser. - Sutton. - (March 2016) ; p. 30-33, 2016.

[24] For a deep dive analyses on the OECD Actions there are studies in which different classifications are discussed by several scholars. Of great importance the work of Y. Brauner, "What the BEPS?" in Florida Tax Review, Vol. 16/2014 Fasc. 2, pag. 69.

[25] Melinda Brown Presentation, OECD Senior Transfer Pricing Advisor, discussed on Mazars International Tax Conference in London on October 13th 2016.

develops detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. [26] On this Action in particular D. Spencer, by detecting the pillars of BEPS project, focuses his attention on the increasing importance on intangible assets as source of income. [27]

Action 2

By neutralizing the effects of hybrid mismatch arrangements, Action 2 develops model treaty provisions and recommendations regarding the design of domestic rules to eliminate the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. [28]

Action 3

This Action, by strengthening the rules for controlled foreign corporations, develops recommendations regarding the design of controlled foreign company rules. [29] This is indeed an important component of the anti-BEPS initiative. The reform of anti-deferral regimes, such as CFC rules, supposedly makes sense within the project. [30] The work of the OECD is to make a worldwide effort to create harmonization between different jurisdictions. With the CFC rule, OECD wants to create a new international system in which each State, for the sake of common international taxation, actively participates in designing, implementing and obeying similar CFC rules. [31]

Action 4

The action, by limiting base erosion via interest deductions and other financial payments, develops recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expenses. [32] For example, with related-party and third party

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[26] Background brief, Inclusive Framework on BEPS, OECD January 2017.

[27] For further analysis refers to D. Spencer, "OECD BEPS Project: Transfer Pricing (Part 1)" in Journal of International Taxation, Vol. 11/2013 pag. 25.

[28] Background brief, Inclusive Framework on BEPS, OECD January 2017.

[29] Ibidem.

[30] Y. Brauner, "What the BEPS?" in Florida Tax Review, Vol. 16/2014 Fasc. 2 pag. 85.

[31] R. Robillard, "BEPS Action 3 Missing in Action: CFC Rules or Global Apportionment?" in Tax Management Transfer Pricing Report, Vol. 24/2015, n. 3, pag. 2.

[32] OECD/G20, Action 5, Harmful Tax Practices.

debt, it achieves excessive interest deductions or finances the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. This action item, besides taking a conservative approach lending to perfection of best practices at the domestic level, it seems that in this context such best practices must include actual solution on which countries would be expected to converge. [33]

Action 5

Studies how to counter harmful tax practices [34] more effectively and, by taking into account transparency and substance, revamps the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. [35] It is clear therefore that the main outcome of this action is to ensure the integrity of tax regimes by addressing the problems caused by favorable regulations that apply to dynamic activities and which unjustly erode the tax base of other countries by distorting the allocation of capital. [36]

Action 6

This work, by preventing treaty abuse or "treaty shopping", develops model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. [37] The concept of treaty shopping refers to techniques that consist in the use of the Conventions against double taxation in order to gain further advantages from a fiscal point of view. [38]

Action 7

Develops changes to the definition of permanent establishment to prevent the artificial avoidance of permanent establishment status in relation to BEPS, including the use of

[33] Y. Brauner, "What the BEPS?" in Florida Tax Review, Vol. 16/2014 Fasc. 2 pag. 90.

[34] For better comprehension see real life case analyzed in V. Ting, "iTax - Apple's Internatinal Tax Structure and the Double Non-Taxation Issue", in British Tax Review, n. 1, 2014.

[35] Background brief, Inclusive Framework on BEPS, OECD January 2017.

[36] OECD, "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5: 2015 Final Report", OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris 2015

[37] Background brief, Inclusive Framework on BEPS, OECD January 2017.

[38] P. Valente, I. Caraccioli, "Treaty shopping e beneficiario effettivo: profili penal-tributari" in Il fisco 10/2016 pag 935

commissionaire arrangements, the specific activity exemptions and the reform of the international tax regime rules applicable to business income. [39] These rules provide that only meaningful presence of business conducted by a non-resident would trigger taxation by the source country where the business is conducted. This is why those rules establishes a PE threshold to determine the instance when business would be considered meaningful enough to trigger taxation. [40]

Action 8 – 10

Aggressive transfer pricing is the beating heart of BEPS planning, the sine qua non of the transactions that triggered the universal interest in BEPS and eventually the BEPS project. [41] Thus, Actions 8-10 work to assure that transfer pricing outcomes are in line with value creation including work on:

- intangibles by developing rules to prevent BEPS from moving intangibles among group members;
- risks and capital by developing rules to prevent BEPS from transferring risks among, or allocating excessive capital to, group members;
- other high-risk transactions that develop rules to prevent BEPS from engaging in transactions which would not, or would only very rarely, occur between third-parties. [42]

Action 11.

By establishing methodologies to collect and analyzing data on BEPS and the actions to address it, develops recommendations regarding indicators of the scale and economic impact of BEPS and ensures that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. [43] This continuous evolution requires constant monitoring [44] on BEPS project.

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[39] Background brief, Inclusive Framework on BEPS, OECD January 2017.

[40] Y. Brauner, "What the BEPS?" in Florida Tax Review, Vol. 16/2014 Fasc. 2, pag 94.

[41] Y. Brauner, "What the BEPS?" in Florida Tax Review, Vol. 16/2014 Fasc. 2, pag 96.

[42] OECD/G20 Base Erosion and Profit Shifting Project, Action 2, 2015 Final Report, Summaries of the Report, Annex 1 – Overview of the BEPS Packages;

[43] Background brief, Inclusive Framework on BEPS, OECD January 2017.

[44] P. Valente, "Erosione della base imponibile e "profit shifting": "focus" sugli aggiornamenti dell'OECD" in Corriere Tributario 41/2014, pag. 3180;

Action 12

This action, by requiring taxpayers to disclose their aggressive tax planning arrangements, develops recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures. [45] It is essential that the rules on mandatory disclosure take into account the balance between additional compliance costs for businesses and benefit in terms of more information and timeliness of information obtained from financial administrations. [46]

Action 13

Re-examining transfer pricing, Action 13, by taking into consideration the compliance costs for business, develops rules on transfer pricing documentation to increase transparency for tax administrations. [47] Two important […] key deliverables of Action item 13 in the tax community are

- the standardization of a core of transfer pricing-related information reporting
- the mandate of country-by-country reporting of MNE operations. [48]

Action 14

Develops solutions to address obstacles that prevent countries from solving treaty-related disputes under mutual agreement procedures (MAP) [49], including the absence of arbitration provisions in most treaties and the fact that the access to MAP and arbitration may be denied in certain cases. [50]

Action 15

[45] Background brief, Inclusive Framework on BEPS, OECD January 2017.

[46] C.HJI Panay, "Advanced issues in international and European tax law", Bloomsbury Publishing, 2015, pag.135

[47] Background brief, Inclusive Framework on BEPS, OECD January 2017.

[48] Y. Brauner, "What the BEPS?" in Florida Tax Review, Vol. 16/2014 Fasc. 2, pag. 104;

[49] Secondo la circolare n.21/E del 5 Giugno 2012 le procedure amichevoli (MAP) sono "lo strumento per la risoluzione delle controversie internazionali, nelle situazioni in cui un soggetto residente di uno dei due Stati contraenti ritenga che le misure adottate da una o entrambe le Amministrazioni finanziarie comportano o comporteranno nei suoi confronti un'imposizione non conforme alle disposizioni della Convenzione".

[50] OECD, Action Plan on Base Erosion and Profit Shifting, July 2013.

By developing a multilateral instrument with the aim of modifying bilateral tax treaties, Action 15 provides an analysis of the issues of tax and public international law related to the development of a multilateral instrument by enabling countries to implement measures developed in the course of the work of BEPS and amend bilateral tax treaties. [51]

It is of critical importance that these recommendations, described here on the matter of the BEPS project, will allow to reach out a contact point between the need of the multinational companies to legally reduce their fiscal burden and the necessity of the tax administration to avoid the loss of the tax base caused by the aggressive tax planning. [52]

2.3 - Action 2: Neutralizing the effects of Hybrid Mismatches Arrangements

For the purpose of this thesis it is necessary to focus on the Action 2[53]. As said in the previous paragraph Action 2 develops model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effect of hybrid instruments and entities (e.g. double non-taxation, double deduction, and long-term deferral). [54] In particular, the work of the scholar Peterson J. on the Action 2 is critical. [55]

The OECD G20 BEPS project calls for an end of hybrid financial instruments that make taxable income disappear. For example, Company A base in a European Country, makes a payment to company B, a related firm based outside Europe. The transaction is packed as a complex financial instrument: a convertible bond. Under the jurisdiction of Country A, the payment is treated as interest and deductible for tax purposes. Instead, under the jurisdiction of Country B, the payment is treated as a dividend and benefits from a tax exemption. The result is a deduction in the jurisdiction of Country A without taxation in the jurisdiction in Country B. So what is the solution to the lack of co-ordination in the two countries' laws?

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[51] OECD/G20 Base Erosion and Profit Shifting Project, Action 2, 2015 Final Report, Summaries of the Report, Annex 1 – Overview of the BEPS Packages;

[52] P. Valente, "Rapporto OECD 2011: tax planning aggressivo e legittimo" in Corriere Tributario 28/2011 pag. 2304.

[53] See Carman, P. BEPS Action 2: hybrid mismatch arrangements, in Derivatives and financial instruments. - Amsterdam. - Vol. 17 (2015), no. 3 ; 13 p.

[54] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2, 2015 Final Report".

[55] Peterson, J., Action 2: Neutralizing the effect of hybrid mismatch arrangements, International tax review. - London. - Vol. 26 (2015), no. 10 (December 2015/January 2016) ; p. 26-27, 2015;

Domestic law changes. Under the BEPS project, countries will deny tax exemption for payments that are deductible in other jurisdiction. If this does not happen countries will neutralize the mismatch by denying the deduction claimed by the payer. In this way it is possible to eliminate hybrid mismatch.
There are four reports based on Hybrid Mismatches arrangements: the *Interim Report*, published in 2014, which was only a draft report; the *2015 Final report*, which was the final report based on the 2014 Interim report; the *Discussion Draft* published in 2016; and finally the more complete report is the *2017 Report* focused on branch Mismatch Arrangements.
Nonetheless, only two reports published in 2015 and 2017 have been fundamental for the comprehension and the analysis of this topic. These reports however are not the final ones, because others are going to be published in the next few years to make corrections and implementations. [56]

2.3.1 - OECD/G20 Base Erosion and Profit Shifting Project, Neutralizing the Effects of Hybrid Mismatches Arrangements, 2015 Final Report

This report, deeply discussed by Girona in his study[57], supersedes the interim report "Neutralizing the Effect of Hybrid Mismatch Arrangements" (OECD, 2014) that was released as part of the first set of BEPS deliverables in September 2014. Compared to that report, the recommendations in Part I added further guidance and examples to explain how the rules have been introduced. Further work has also been undertaken on asset transfer transactions (such as stock-lending and repo transactions), imported hybrid mismatches, and the treatment of a payment that is included as income under a controlled foreign company (CFC) regime. [58]
As explained in the 2014 Interim report, countries can still decide freely their policy choices regarding whether the hybrid mismatch rules should be applied to misalignments arising because of intra-group hybrid capital. One country can chooses not to apply these rules to neutralize a hybrid mismatch in respect of a particular hybrid instrument. This will not damage other country's policy choices. The OECD, "Neutralizing the Effects of Hybrid

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[56] See references to the studies of the first International Commentators on Hybrid Mismatches, v.

- De Boer R., Marres O., BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements, in Intertax, n. 43, Issue 1, 2015, pag. 14 ss.;
- De Broe L., At Last, Some Output on the Fight…, cit.;
- Dourado A. P., May You Live In Interesting Times, in Intertax, n. 44, 2016, Issue 1, pag. 2 ss.

[57] Girona, E., New anti-hybrid and anti-abuse tax measures, Derivatives and financial instruments. - Amsterdam. - Vol. 17 (2015), no. 5 ; 7 p., 2015;

[58] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2, 2015 Final Report".

Mismatch Arrangements", Action 2, Executive Summary on 2015 Final Report describes with interesting details the two sections in which the above-cited Report is divided. The description of the two sections are reported below.

Part I of the report identifies recommendations for regulations to address mismatches in tax outcomes whether they arise in respect of payments made under a hybrid financial instruments or payment made to or by a hybrid entity. [59] It suggests also rules to marks indirect mismatches that arise when the effects of a hybrid mismatch arrangement are brought into a third jurisdiction. These recommendations are transposed into a form of linking rules that bring at the same level the tax treatment of an instrument or entity and the tax treatment in the counterparty jurisdiction. This without interfering with the commercial outcomes. [60] The rules apply automatically and there is a rule order in the form of a primary rule and a secondary or defensive rule. This prevents more than one country to apply the rule for same arrangements and avoid double taxation. [61]

The recommendation of the primary rule is that countries deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction. If the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch. [62]

The report recognizes the importance of co-ordination in the implementation and application of the hybrid mismatch rules to ensure that the rules are effective and to minimize compliance and administration costs for taxpayers and tax administrations. It sets out a common set of design principles and defined terms intended to ensure consistency in the application of the rules. [63]

Part II addresses the section of Action 2 aimed at ensuring that hybrid instruments and entities, as well as dual resident entities, are not used to obtain unduly the benefits of tax

[59] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2, 2015 Final Report".

[60] HJI Panayi C., International Tax Law Following the OECD/G20 Base Erosion and Profit Shifting, in European Union/International/OECD, 2016;

[61] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2, 2015 Final Report".

[62] Ibidem.

[63] OECD/G20, Neutralize the Effects of Hybrid Mismatches Arrangements, Action 2, 2015 Final Report.

treaties and that tax treaties do not prevent the application of the changes to domestic law recommended in Part I. [64]

Part II examines the issue of dual resident entities, i.e. entities that are residents of two States for tax purposes.

Part II also deals with the application of tax treaties to hybrid entities, i.e. entities that are not treated as taxpayers by either or both States that have entered into a tax treaty (such as partnerships in many countries). The report proposes to include in the OECD Model Tax Convention (OECD, 2010) a new provision and detailed Commentary that will ensure that benefits of tax treaties are granted, in appropriate cases, to the income of these entities, but also that these benefits are not granted if neither State treats, under its domestic law, the income of such an entity as the income of one of its residents. [65]

Finally, Part II addresses potential treaty issues that could arise from the recommendations in Part I. It first examines treaty issues related to rules that would result in the denial of a deduction or would require the inclusion of a payment in ordinary income and concludes that tax treaties would generally not prevent the application of these rules. [66] It then examines the impact of the recommendations of Part I with respect to tax treaty rules related to the elimination of double taxation and notes that problems could arise in the case of bilateral tax treaties that provide for the application of the exemption method with respect to dividends received from foreign companies. The report describes possible changes in treaty that would address these problems. The last issue dealt with in Part II is the possible impact of tax treaty rules concerning non-discrimination on the recommendations of Part I. [67]

2.3.2 - OECD/G20 Base Erosion and Profit Shifting Project, Neutralizing the Effects of Branch Mismatch Arrangements, 2017 Report

As introduced in the paragraph above there is an Executive Summary for the OECD/G20 Base Erosion and Profit Shifting Project, Neutralizing the Effects of Branch Mismatch Arrangements, 2017 Report. Hereafter is reported an extract of it. The 2017 report sets out recommendations for branch mismatch rules that would bring the treatment of these structures

[64] OECD/G20, Neutralize the Effects of Hybrid Mismatches Arrangements, Action 2, 2015 Final Report.

[65] Ibidem.

[66] OECD/G20, Neutralize the Effects of Hybrid Mismatches Arrangements, Action 2, 2015 Final Report, Executive Summary.

[67] Ibidem.

into line with the treatment of hybrid mismatch arrangements as set out in the 2015 Report on Neutralizing the Effects of Hybrids Mismatch Arrangements (Action 2 Report). [68] Branch mismatches arise where the ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping the charge to taxation in both the branch and residence jurisdiction. Unlike hybrid mismatches, which result from conflicts in the legal treatment of entities or instruments, branch mismatches are the result of differences in the way the branch and head office account for a payment made by or to the branch. [69] The 2017 report identifies five basic types of branch mismatch arrangements that give rise to one of three types of mismatches: deduction / no inclusion (D/NI) outcomes, double deduction (DD) outcomes, and indirect deduction / no inclusion (indirect D/NI) outcomes. This report includes specific recommendations for improvements to domestic law intended to reduce the frequency of branch mismatches as well as targeted branch mismatch rules that adjust the tax consequences in either the residence or branch jurisdiction in order to neutralize the hybrid mismatch without disturbing any of the other tax, commercial or regulatory outcomes. The annexes of the report summaries the recommendations and set out a number of examples illustrating the intended operation of the recommended rules.[70]

[68] OECD/G20 Base Erosion and Profit Shifting Project, 2015 Final Report, Executive Summary.

[69] OECD Website, OECD/G20 Base Erosion and Profit Shifting Project, 2017 Report, Executive Summary.

[70] Ibidem.

3 – The Anti-Tax Avoidance Package

Imagine a world in which everyone pays their fair share of taxes and have these revenues by keeping up schools, hospitals and a public transport running always on time. Unfortunately, this is not a perfect world. Some multinational companies operating in Europe do not pay their amount of taxes and that means billions in lost tax revenues. That money that are not going to be used for schools, hospitals or public services like buses and trains are going to be wasted.

This tax avoidance by large multinational firms can also result in a higher taxes built for everyone else. Tax avoidance is made possible by all the loopholes, complexities and inconsistencies in the tax loss of different EU countries. If one country's tax laws are not in tune with the others, multinational companies can take advantage, and they do so because every year about one in five euros of corporate tax is lost in tax avoidance. This is why the European Commission is pushing back. It is time to stop imaging a simpler system, and start building it. It is time for fair and effective taxation for all Europeans.

Only a few months after the OECD released its Base Erosion and Profit Shifting (BEPS) package for the reform of the international tax system to tackle perceived tax avoidance, [71] the European Commission presented a set of proposals titled the "Anti-Tax Avoidance Package". [72]

Before proceed further with the explanation of the Anti-Tax Avoidance Package and the Anti-Tax Avoidance Directive, I think it is crucial pointing out that the BEPS package is a different report compared to the ATA directive. BEPS project provides only recommendations that Countries can decide to implement or not. OCSE does not force Countries to adopt these new measures on different matters, it only gives suggestions on how to detect and how to avoid such a new measures. [73] On the other hand, ATA Directive is a document provided by the European Union and gives rules that every European Countries must adopt. ATA Directive does not give recommendations, but provides defining rules. To sum up this subsection, we

[71] OECD, "Final BEPS package for reform of the international tax system to tackle tax avoidance," Oct. 2015.

[72] European Commission, Press Release, Jan. 28, 2016, "Fair Taxation: Commission presents new measures against corporate tax avoidance."

[73] Liebman, H.M. [et al.], EU update: the anti-tax avoidance package, Tax planning international: European tax service. - London. - Vol. 18 (2016), no. 3 ; 6 p., 2016

can say that the main difference from BEPS project and the ATA Directive is that the BEPS project provides only *"soft"* laws while the ATA Directive imposes *"hard"* laws.
The "tax avoidance package" consists of a series of EU legislative and non-legislative initiatives with the scope of strengthening the rules against corporate tax avoidance and making company taxation in the EU fairer, simpler and effective. [74]
It is based on the recommendations of the OECD (Organization for Economic Cooperation and Development) formulated in 2014 to address the problem of tax base erosion and profit transfer.
The Package contains concrete measures to prevent aggressive tax planning, boost tax transparency and create a leveled playing field for all businesses in the EU. [75] It will help Member States take strong and coordinated action against tax avoidance and ensure that companies pay tax wherever they make their profits in the EU. [76] [77]

The sections of the Anti-tax avoidance package [78] are *Chapeau Communication*, which enumerate the political, economic and international context of the Anti-Tax Avoidance Package and highlights the elements of disparities between parties; *Anti-Tax Avoidance Directive,* which will be discussed deeply in the following chapter, lists five pillars that every Member States should follow to operate against aggressive tax planning. The scope of this Directive is to give EU a defense shield against corporate tax avoidance, while ensuring a easier and stable environment for businesses. The *Revision of the Administrative Cooperation Directive* passes a country by country reporting project to be adopted by Member States' tax authorities with the aim of improving tax-related information on companies which operates in the European Union. The critical element in the country-by-country reporting is that the information must be of maximum importance. Another pillar of the ATA [79] package is the *Recommendation on Tax Treaties* that has the scope of toughen the Member States' tax

[74] F. Vicentini, F. Pecorari, "Disallineamenti da ibridi con Paesi Terzi: nuove regole contro l'elusione fiscale" in Il Quotidiano IPSOA del 6 Giugno 2017.

[75] Anti-Tax Avoidance Package, Website https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en.

[76] Valente P., "Il recepimento della direttiva ATAD 1 (come modificata dalla Direttiva 2) da parte dell'Italia", Maggio, 2018.

[77] Anti-Tax Avoidance Package, Website https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en.

[78] Senato della Repubblica, "Norme contro le pratiche di elusione fiscale (direttiva ATAD 2)", dossier 12 Settembre 2018.

[79] Anti-Tax Avoidance (ATA).

treaties against every aggressive tax planners. It contains a brief description of general anti-abuse rules and definition of permanent establishment. On the next section regarding *Communication on an External Strategy for Effective Taxation,* the European Union introduces a new approach for third countries. The relations with a hypothetical third country it is therefore suggested according to this pillar. For tax purposes, therefore, there is an EU list of third countries. Finally yet importantly, we have the fifth pillar: the *Study on Aggressive Tax Planning.* This section understands and discovers Member States' corporate tax rules that, according to the European Union legal system, could harm competition by facilitating aggressive tax planning and tax exemption.

To make the job easier for EU Member States this section includes factsheets with the main findings for each Member State and examples of tactics used by multinationals to lower their taxes.[80]

The next chapter will be focused on the principals of the Anti-Tax Avoidance Directive (ATAD).

3.1 - Anti-Tax Avoidance Directive (ATAD)

The scope of the Anti-Tax Avoidance Directive, national directive **2016/1164/UE** which is part of the Anti-Tax Avoidance Package of the EU, is to introduce in the EU countries a set of rules for preventing tax avoidance. The focal point of this directive is to create a fairer, simpler and more effective corporate taxation in the EU. [81]

One of the key elements of this Anti-Tax Avoidance Package is the "Anti-Tax Avoidance Directive" that proposes five legally binding anti-abuse measures, which all Members should apply against common forms of aggressive tax planning. [82] Anti-tax avoidance and aggressive tax planning preventive measures, established by the ATAD, has the job of granting a single tax principle in cross border taxation by eliminating disparities between national tax systems,

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[80] Anti-Tax Avoidance Package, European Commission Website, https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en.

[81] Rigaut A., "Anti-Tax Avoidance Directive (2016 / 1164): New EU Policy Horizons," European Taxation, 2016, 497.

[82] Bhogal, S., The EU anti-tax-avoidance directive, Tax notes international. - Falls Church. - Vol. 83 (2016), no. 10 ; p. 881-884, 2016;

which create loopholes. These measures intervene in fiscal sovereignty of the Member States in an attempt to ensure allocation of taxing powers based on the principle of fair taxation. [83] In general, "tax avoidance" is defined as unacceptable or abusive, whereas "tax planning" is acceptable and sometimes encouraged by the law. [84]

In the Directive, there are the following areas of work. The *controlled foreign companies (CFC) rule* [85] has the role of deterring profit shifting to a law/no tax country. Before the introduction of this rule, companies were able to shift their profits to dependent companies in low/no tax countries reducing the taxable profit in the EU. With the use of the CFC rule, companies can still shift their profits, but those profits will now be taxable in the EU. The *switchover rule*, as a second measure, will prevent double non-taxation of certain income. An EU based company, at first, invests in another company based in a low-tax country outside the EU. Dividends are then, in turn, paid back to the EU-based company, where Member States treat them as having already been properly taxed in the third country. Nevertheless, this is rarely the case. Thanks to the new rule, happens that Member States would have to tax dividends into the EU if they have not already been properly taxed. The *exit taxation rule* is the third measure, which prevent companies from avoiding tax when re-locating assets. Big multinationals allocate huge amount of time and energy developing new products. Therefore, companies based in the EU can develop a promising new product and move it to a no-tax country before it is finalized. In this way, the company pays less tax on the profits in the EU. The new tax exit rule ensure that Member States can impose tax on the value of the product before it is moved out of the EU. The Exit Taxation targets unrealized appreciation of assets to taxation based on the market value when the assets, residence or business leaves the tax jurisdiction. The market value is the amount for which an asset can be exchanged or a mutual obligations can be settled between willing and unrelated buyers and sellers in a direct transaction. [86] The role of deterring unnatural debt agreement created to lower taxes is describe in *Interest limitation* section. Giving an example to better understand the issue, a company based in the EU builds a subsidiary in a low tax country providing a loan back to the

[83] Ana Paula Dourado, "The EU Anti-Tax Avoidance Package: Moving Ahead of BEPS," Intertax 44, no. 6,7 (2016): 441.

[84] Christine Alves Alvarrenga, "Preventing Tax Avoidance: Is There Convergence in the Way Countries Counter Tax Avoidance?", Bulletin for International Taxation, 2013, 348–63.

[85] Serena A., Pavanetto S., "Modifiche alla disciplina CFC e alla tassazione dei dividenti e plusvalenze black list", Fiscalità Internazionale, Bilancio e Reddito d'impresa n. 3/2019.

[86] ATAD Directive, Council Directive (EU) 2016/1164, of 12 July 2016.

company or another company again based in the European Union soil. According to these facts, the EU-based company will have high interest and tax-deductible payments back. Interest limitation rules would limit the amount of interest that a company can deduct. [87] This will increase the amount of tax it pays. [88]

The last measure adopted and developed by the ATAD directive, is the *general anti abuse rule* that confront aggressive tax planning if other rules cannot be applied. Previously, companies engaged in aggressive tax planning always tried to find ways to bypass rules and find loopholes in tax laws. Now, General anti-abuse rules (GAAR) give EU countries the power to tackle artificial tax arrangements if other specific rules do not cover it. The Commission explains that the political objective of the GAAR is to close any gap in respect of existing specific anti-abusive mechanisms in this area. These Abusive Tax Planning schemes develop rapidly and the tax legislation is unable to keep up with their pace. This is why the GAAR is a useful tool in taxation to capture tax-avoidance practices despite the absence of a specific anti-avoidance rule. [89]

This European Directive 2016/1164 took the burden of fighting the tax avoidance practices, which could and already have an active part in the internal market of the country. There are therefore several limits to aggressive tax planning with respect to the corporate groups, which exploit differences between internal and external national fiscal systems.

There are numerous pillars to be set in order to fully understand the aim of the ATAD Directive. A fertile soil must be arranged in order to let this directive affect the European Economy. Before discussing the main articles of this Directive, it is crucial to understand some principles behind that.

It is critical therefore to restore the trust in the fairness of tax systems and to allow governments to effectively operate their fiscal sovereignty. These new political objectives have been translated into “recommendations” for concrete actions in the framework of the initiative against erosion of the tax base and profit transfer (BEPS) of the Organization for

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[87] Anti-Tax Avoidance Package Factsheets, from the European Commission Website.

[88] Helminen, EU Tax Law: Direct Taxation, 66;

[89] Popa, O., An overview of ATAD implementation in EU Member States, European taxation. - Amsterdam. - Vol. 59 (2019), no. 2/3 ; p. 120-122, 2019;

Economic Cooperation and Development (OECD).[90] A common framework could prevent a fragmentation of the market and put an end to currently existing mismatches and market distortions. National implementing measures, therefore, would provide taxpayers with legal certainty in that those measures would be compatible with Union law.[91]

It is necessary to lay down rules in order to strengthen the average level of protection against aggressive tax planning in the internal market, with the aim to improve its effectiveness as a whole in confronting tax avoidance practices.[92]

It is necessary to define rules against the erosion of tax bases in the internal market and the shifting of profits out of the internal market. Regulations are necessary in achieving the main objectives which are the limitation to the deductibility of interest, exit taxation, a general anti-abuse rule, controlled foreign company rules and rules to tackle hybrid mismatches. These guidelines should not only aim to counter tax avoidance practices, but also to avoid creating other obstacles to the market, such as double taxation.[93]

In the following part, I will give a complete description of the main elements of the Council Directive 2016/1164 and then I will compare it with the most recent one.

Trying to reduce their global tax liability, companies have engaged in BEPS, through excessive interest payments. The interest limitation rule is necessary to discourage such practices by limiting the deductibility of taxpayers' exceeding borrowing costs. [94] It is therefore necessary to fix a ratio for deductibility, which refers to a taxpayer's taxable earnings before interest, tax, depreciation and amortization (EBITDA). [95]

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[90] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 1.

[91] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 2.

[92] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 3.

[93] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 5.

[94] See the Interest Limitation rule (Article 4 ATAD).

[95] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 6

Where the taxpayer is part of a group, which files statutory consolidated accounts, the indebtedness of the overall group at worldwide level may be considered for the purpose of granting taxpayers entitlement to deduct higher amounts of exceeding borrowing costs.
The interest limitation rule should apply in relation to a taxpayer's exceeding borrowing costs without distinction of whether the costs originate in debt taken out nationally, [96] cross-border within the Union or with a third country, or whether they originate from third parties, associated enterprises or intra-group.[97]
To reduce the administrative and compliance burden of the rules without significantly diminishing their tax effect, it may be appropriate to provide for a safe harbor rule so that net interest is always deductible up to a fixed amount, when this leads to a higher deduction than the EBITDA-based ratio. Member States could reduce the fixed monetary threshold in order to ensure a higher level of protection of their domestic tax base. Since BEPS, in principle, takes place through excessive interest payments among entities, which are associated enterprises, it is appropriate and necessary to allow the possible exclusion of standalone entities from the scope of the interest limitation rule, given the limited risks of tax avoidance. In order to facilitate the transition to the new interest limitation rule, Member States could provide for a grandfathering clause that would cover existing loans to the extent that their terms are not subsequently modified. [98]

Exit taxes have the function of ensuring that where a taxpayer moves assets or its tax residence out of the tax jurisdiction of a State, that State taxes the economic value of any capital gain created in its territory even though that gain has not yet been realized at the time of the exit. It is therefore necessary to specify cases in which taxpayers are subject to exit tax rules and taxed on unrealized capital gains, which have been built in their transferred assets. The right to tax should be defined at national level. [99]

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[96] European Parliament Documents, Report on the proposal for a Council directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, 27 May 2016.

[97] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 7

[98] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 8

[99] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 10

General anti-abuse rules (GAARs) are present in tax systems to tackle abusive tax practices. GAARs should be applied to arrangements that are not genuine, otherwise the taxpayer should have the right to choose the most tax efficient structure for its commercial affairs. It is furthermore important to ensure that the GAARs apply in domestic situations, within the Union and vis-à-vis third countries in a uniform manner, so that their scope and results of application in domestic and cross-border situations do not differ. [100]

Controlled foreign company (CFC) rules have the effect of re-attributing the income of a low-taxed controlled subsidiary to its parent company. Then, the parent company becomes taxable on this attributed income in the State where it is resident for tax purposes. In particular, in order to ensure that CFC rules are a proportionate response to BEPS concerns, it is critical that Member States, that limit their CFC rules to income which has been artificially diverted to the subsidiary, precisely target situations where most of the decision-making functions which generated diverted income at the level of the controlled subsidiary, are carried out in the Member State of the taxpayer. It is necessary that the CFC rules extend to the profits of permanent establishments which are not subject to tax or are tax exempt in the Member State of the taxpayer. In order to ensure a higher level of protection, Member States could reduce the control threshold, or employ a higher threshold in comparing the actual corporate tax paid with the corporate tax that would have been charged in the Member State of the taxpayer. In transposing CFC rules into their national law, Member States use white, grey or black lists of third countries, which are compiled based on certain criteria set out in this Directive and may include the corporate tax rate level. [101]

Hybrid mismatches are the consequence of differences in the legal characterization of payments (financial instruments) or entities and those differences surface in the interaction between the legal systems of two jurisdictions. The effect of such mismatches is often a double deduction (i.e. deduction in both states) or a deduction of the income in one state without inclusion in the tax base of the other. To neutralize the effects of hybrid mismatch arrangements, it is necessary to lay down rules whereby one of the two jurisdictions in a mismatch should deny the deduction of a payment leading to such an outcome. In this context, it is useful to clarify that measures aimed to tackle hybrid mismatches in this

[100] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 11

[101] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 12

Directive are aimed to tackle mismatch situations attributable to differences in the legal characterization of a financial instrument or entity and are not intended to affect the general features of the tax system of a Member State. [102]

Considering that, a key objective of this Directive is to improve the resilience of the internal market as a whole against cross-border tax avoidance practices, this cannot be sufficiently achieved by the Member States acting individually. It would thus allow inefficiencies and distortions to persist in the interaction of distinct national measures. The result would be lack of coordination. Instead, due to the fact that much inefficiency in the internal market primarily gives rise to problems of a cross-border nature, remedial measures should be adopted at European Union level. It is therefore critical to adopt solutions that function for the internal market as a whole and this can be better achieved at European Union level. This Directive only aims to achieve the essential minimum degree of coordination within the Union for the purpose of materializing its objectives.[103]

As mentioned before there are several areas that compose this directive.
The first area intervenes on the measures against tax avoidance. The article 4 in particular outlines the rules on interest limitation and the Article 5 emphasize the exit taxation directives.
It is worth mentioning some features of the Article 5 regarding the exit taxation.
A taxpayer shall be subject to tax at an amount equal to the market value of the transferred assets, at the time of exit of the assets, less their value for tax purposes, in any of the following circumstances: [104]

1. taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country in so far as the Member State of the head office no longer has the right to tax the transferred assets due to the transfer;
2. taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third

[102] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 13

[103] Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016, paragraph 16

[104] Article 5, paragraph 1, of the Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016;

country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer;

3. a taxpayer transfers its tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State;
4. a taxpayer transfers the business carried on by its permanent establishment from a Member State to another Member State or to a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer.

Article 6 introduces the General Anti-Abuse Rule (general anti-abuse clause) according to which, due to the imposition of companies, Member States are required to ignore the constructions (legal or fiscal) which, put in place for the purpose main to obtain a tax advantage in contrast to the object or purpose of the applicable law, they are not genuine having regard to all relevant facts and circumstances. A construction or a series of constructions are considered "not genuine" to the extent that they have not been put in place for valid commercial reasons that reflect economic reality.[105]

Referring to foreign subsidiaries (controlled foreign companies - CFCs), the directive (article 7) pursues the aim of preventing corporate groups from transferring their profits to group companies based in States with taxation that is more favorable to the purpose to reduce the overall tax burden. As also emerges from the recitals, the rules on CFCs intend to re-allocate the income of a subsidiary company subject to low taxation to the parent company; the latter is therefore taxable for the income that has been attributed to it in the State in which it is resident for tax purposes. Member States may exempt from this regulation some entities with low earnings or a low profit margin that involve lower risks of tax avoidance.

The article 7 says that the Member State of a taxpayer shall treat an entity, or a permanent establishment of which the profits are not subject to tax or are exempt from tax in that Member State, as a controlled foreign company where the following conditions are met:

a) in the case of an entity, the taxpayer by itself, or together with its associated enterprises holds a direct or indirect participation of more than 50 percent of the

[105] Article 6, paragraph 1, of the Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016;

voting rights, or owns directly or indirectly more than 50 percent of capital or is entitled to receive more than 50 percent of the profits of that entity;

b) the actual corporate tax paid on its profits by the entity or permanent establishment is lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment.[106]

The directive also deals with regulating the so-called phenomenon of the hybrids mismatches. The Article 9 of the directive describes a situation arising between a taxpayer in a Member State and an associated company in another Member State. There can be two outcomes as per article 9.

One type of hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source.

The other results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.[107]

To prevent transnational groups from taking advantage of differences in the Member States' legislative systems to reduce their tax burden, Article 9 of the directive provides that to the extent that a hybrid mismatch causes a double deduction, the deduction apply only in the Member State where the payment originates.

On May 29th 2017, a new version of the Council Directive 2016/1164 was published. [108] The Council of the European Union, to shed lights on a particular and fundamental topic, created the new Directive. This matter was only mentioned in the article 9 of the previous Directive and so, since this is of critical importance nowadays, the new Council Directive 2017/952 is precisely focus on it. This new subject is the hybrid mismatch

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[106] Article 7, paragraph 1, of the Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016;

[107] Article 9 paragraphs 1-2, of the Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016;

[108] Semonella F., "Brevi rilessioni in tema di edit tax alla luce dell'attuazione della direttiva ATAD", rivista di Diritto Tributario online, 31 Gennaio 2019.

To better understand the concept of hybrid mismatches, a newer vision of them will be the focus of the next chapter regarding their main differences between the ATAD1 and the so-called ATAD2.

4 - Hybrid Mismatches

4.1 - History

Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. [109] These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness. [110]
The concept of hybrid mismatch is an issue that has been addressed in time and scholars have always tried to find effective methods to contrast this. Initially with poor results and then subsequently, with the recent regulations and Legislative Decree, an attempt was made to provide a concrete and truthful analysis of this longstanding topic. The legislative body that tried to find a solution and that worked the most on the analysis of hybrid mismatches was the Organization for Economic Cooperation and Development (OECD).
OECD uses its wealth of information on a broad range of topics to help governments foster prosperity and fight poverty through economic growth and financial stability. [111] It helps ensure the environmental implications of economic and social development. OECD's work is based on continuous monitoring of events in member countries as well as outside OECD area, and includes regular projections of short and medium-term economic developments. The OECD Secretariat collects and analyses data after which committees discuss policy regarding this information, the Council makes decisions, and then governments implement recommendations. [112]

The mission of the OECD is to promote policies that will improve the economic and social well-being of people around the world. The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems.
The OECD has several core values that drives their choices. OECD must have an objective, their analyses and recommendations are independent and evidence-based. OECD has to be

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[109] OECD/G20, Base Erosion and Profit Shifting, Action 2, “Neutralising the Effectd of Hybrid Mismatch Arrangements”, 2015 Final Report;

[110] Financial Times, “Successive restructuring allowed Moody’s to cut tax rate”;

[111] OECD website http://www.oecd.org/.

[112] Ibidem.

open by means of encouraging debate and understanding critical issue. A bold shade of behavior and being a pioneer is crucial to challenge conventional wisdom and address emerging and long-term challenges. The last, but not least, core value is ethic, the OECD credibility is built on trust, integrity and transparency.

OECD has begun treating the hybrid mismatch issue in 2010 when it published “Addressing Tax Risks Involving Bank Losses”. This report highlighted the use of hybrid mismatches in context of international banking and recommended that revenue bodies “bring to the attention of their government tax policy officials those situations which may potentially raise policy issues.[113]

A similar content has been reformulated for the OECD, 2011 report on “Corporate Loss Utilization through Aggressive Tax Planning”. That new report recommended countries to consider introducing restrictions on multiple use of the same loss to the extent they are concerned with these results. Both of these reports have been introduced to obviate to some negative impact that hybrid mismatches have on competition, efficiency, transparency and fairness.

Following these first two reports, concerns have been raised by a number of OECD member countries. As a result, the OECD undertook a review with interested member countries to identify examples of tax planning schemes involving hybrid mismatched arrangements and to assess the effectiveness of response strategies adopted by those countries.

The result of these concerns and the review culminated with a new report issued in 2012 by the OECD. The report focused on “Hybrid Mismatches Arrangements: Tax Policy and Compliance Issues”. The Hybrid Mismatch Report set out a number of policy options to address such hybrid mismatches arrangements and concluded that domestic law rules, which link the task treatment of an entity, instrument or transfer to the tax assessment in another country had significant potential as a tool to address hybrid mismatch arrangements. The creation of a policy option called “linking rule” was a solution given as a result of those reports. This option regards a link between the approaches in one country and the treatment in the other countries. Although this “linking rules” make the application of domestic law more complicated, the Hybrid Mismatch Report noted that such rules are not a novelty as, at the beginning, foreign tax credit rules, under tax clauses and controlled foreign company (CFC) rules often do precisely that.

[113] OECD/G20 BEPS Project, Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2, 2015 Final Report;

After the release of the report *Addressing Base Erosion and Profit Shifting* in February 2013, OECD and G20 countries decided to adopt a 15-point Action Plan starting from September 2013. The Action Plan identified 15 actions described in 13 reports concerning three main pillars: introducing coherence in the domestic rules that affects cross-border activities, reinforcing requirements in the existing international standards, and improving transparency and certainty. [114]

After that, the OECD worked on a new report that had a particular focus on Hybrid Mismatches Arrangements. That report develops a model for the neutralization of the effects of hybrid instruments and entities. In fact, at first, in 2014, an "Interim Report" was issued by the OECD under BEPS Action Plan, called "Action 2, Neutralizing the Effects of Hybrid Mismatch Arrangements".

The 2014 "Interim Report" developed a model treaty provisions and recommendations regarding the design of domestic rules to detect and neutralize the effects of hybrid instruments and entities. [115] This may include:

- changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly;
- domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer;
- domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules);
- domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction;
- guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure.

Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. [116]

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[114] OECD/G20, OECD/G20 BEPS Project, "Neutralizing the Effects of Hybrid Mismatch Arrangements", Action 2, 2015 Final Report, "Introduction".

[115] OECD/G20 Base Erosion and Profit Shifting Project, "Neutralizing the Effects of Hybrid Mismatch Arrangements", Action 2, 2014 Interim Report.

[116] OECD/G20 Base Erosion and Profit Shifting Project, "Neutralizing the Effects of Hybrid Mismatch Arrangements", Action 2, 2014 Interim Report.

A new, complete and final report has been issued by the OECD in 2015 with the title "Neutralizing the Effects of Hybrid Mismatch Arrangements". The 2015 final report, divided in two parts, sets out recommendations for domestic rules to neutralize the effect of hybrid mismatch arrangements and includes changes to the "OECD Model Tax Convention" to address such arrangements. Once translated into domestic law, the recommendations in Part I of the report will neutralize the effect of cross-border hybrid mismatch arrangements that produce multiple deductions for a single expense or a deduction in one jurisdiction with no corresponding taxation in the other jurisdiction. Part I of the report, therefore, sets out recommendations for rules to address hybrid mismatches in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity. It also recommends rules to address indirect mismatches that arise when the effects of a hybrid mismatch arrangement are imported into a third jurisdiction. [117] The recommendations are supported by a commentary and examples to illustrate how they should apply these indications. Part II of the report sets out proposed changes to the Model Convention that will ensure that the benefits of tax treaties are only granted to hybrid entities (including dual resident entities) in appropriate cases. Part II also considers the interaction between the OECD Model Convention and the domestic law recommendations in Part 1. [118]

After another two years of work, the newest version of the report has been released in 2017 by the OECD. The precise focus is on of branch mismatches rules that would bring the treatment of these instruments in line with the treatment of hybrid mismatch arrangements as shown in the 2015 Report on Neutralizing the Effects of Hybrids Mismatch Arrangements (Action 2 Report).

The last and new European Directive and Legislative Decree that have been issued on Hybrid Mismatches are the ATA Directive 2, that is going to be analyzed in the following pages, and the Legislative Decree 29 November 2018, n.142, in particular from article 6 to article 11.

4.2 - Hybrid Mismatches through ATAD 1 and 2

[117] OECD/G20 Base Erosion and Profit Shifting Project, Action 2, 2015 Final Report from OECD website www.oecd.org.

[118] Ibidem.

Both Anti-Tax Avoidance Directive (ATAD) 1 and 2 contain specific provisions to tackle hybrid mismatches. As a matter of principle it has been decided to not remove the cause of hybrid mismatches within the internal market, but to counter only a few of the symptoms of hybrid mismatches. [119] Measures from ATAD 1 and 2 are mainly focused on hybrid mismatches caused by the use of (reverse) hybrid entities. Overall, the approach chosen by the European Council does seems to close many of the existing loopholes through which hybrid mismatches are used. The main remaining question is whether all twenty-seven Member States will be able to consistently implement the complex anti-mismatch rules. [120]

Hybrid mismatch is a situation that can happen between a taxpayer in one Member State and an associated enterprise in another Member State or a structured arrangement between parties in Member States, where the following outcomes are attributable to differences in the legal definition of a financial instrument or entity:

- 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 ('double deduction'; c.d. D/D);
- a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion for tax purposes of the same payment in the other Member State ('deduction without inclusion'; c.d. D/NI).[121]

It is worth giving some examples of these outcomes to better understand the importance of such results.

The Fig. 1 below represent the situation described as Double Deduction (D/D).

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[119] OECD/G20 Base Erosion and Profit Shifting Project, Action 2, 2015 Final Report from OECD website www.oecd.org.

[120] Fibbe, G.K.Stevens, A.J.A., Hybrid mismatches under the ATAD I and II, EC tax review. - Alphen aan den Rijn. - Vol. 26 (2017), no. 3 ; p. 153-166, 2017;

[121] Article 2, paragraph 9, of the Official journal of the European Union, COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016;

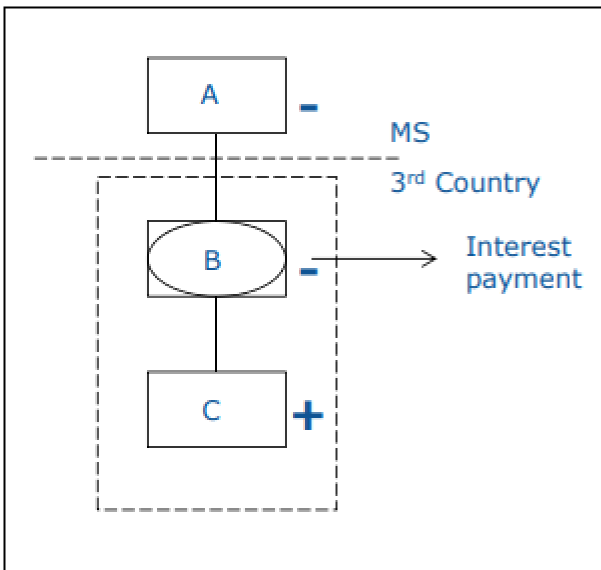

Fig. 2: Double Deduction;

Hybrid Entity B is non-transparent in the third country, but considered as transparent be the Member State (MS). Interest payment is deducted by A Co (Company A) and by Hybrid Entity B and payment by B is set-off against income of C Co under group tax regime. Therefore, based on ATAD 2, the Member state should deny the deduction of the payment.

The next figure shows the hybrid entity situation in which there is a deduction without inclusion (D/NI).

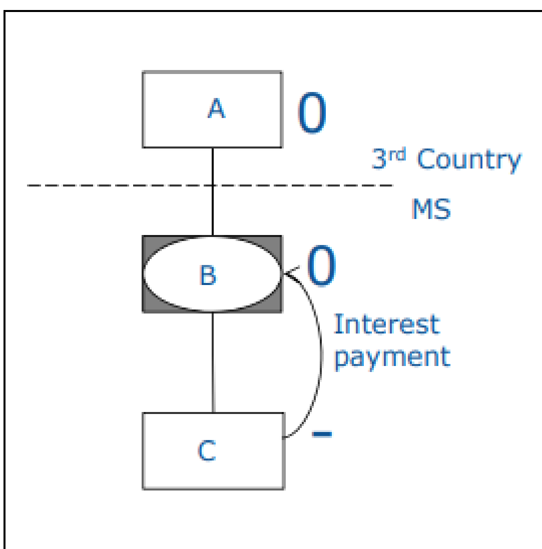

Fig. 3

Hybrid entity B is transparent in the Member State, but considered as non-transparent by the third country (reverse Hybrid Entity). Interest payment to reverse Hybrid Entity B is deducted

by C Co, but is neither included by the reverse Hybrid Entity B nor by A Co. Therefore, based on ATAD 2 instructions, the Member State should deny the deduction of the payment. [122]

The table here below provides a general overview of the hybrid mismatches rules recommended in the OECD/G20 Base Erosion and Profit Shifting Project "Neutralizing the Effects of Hybrid Mismatch Arrangements", Action 2, 2015 Final Report. [123]

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
D/NI	Hybrid financial instrument	No dividend exemption for deductible payments Proportionate limitation of withholding tax credits	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
	Disregarded payment made by a hybrid		Deny payer deduction	Include as ordinary income	Control group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque	Deny payer deduction	-	Control group and structured arrangements
DD	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response, defensive rule applies to control group and structured arrangements
	Deductible payment made by dual resident		Deny resident deduction	-	No limitation on response
Indirect D/NI	Imported mismatch arrangements		Deny payer deduction	-	Members of control group and structured arrangements

Table 1

Hybrid Mismatches, initially mentioned in the Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD 1), are defined as misalignments that occur between two or more jurisdictions in the assessment and identification and regulatory classification of financial instruments, entities or transfers, which involve the creation of hybrids, i.e. entities or instruments that are qualified differently depending on the country of origin.

In the first part we mentioned several pillars which play a central role in the concept of hybrid mismatches and it is necessary, for the understanding of the following chapters, to carefully analyze these players together with a list of visual examples, including graphics.

The active players that characterize hybrid mismatches are:

[122] European Commission, ATAD 2;

[123] OECD/G20 Base Erosion and Profit Shifting Project Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2, 2015 Final Report;

- **financial instruments,** that are defined as "any instrument that gives rise to positive components of income belonging to a legal financing relationship or an investment of capital and subject to taxation according to the corresponding rules regarding debt, equity or derivative relationships, based on the laws of the beneficiary's or payer's jurisdiction; [124]
- **hybrid entity,** that identifies any entity or agreement which, under the legislation of a State, is considered a taxable person for the purposes of income tax and whose positive and negative income components are considered positive and negative components of income of another or other taxable persons under the laws of another jurisdiction; [125]
- **disregarded permanent establishment,** which represents the exercise of activity which, based on the jurisdiction of residence of the tax payer, constitutes a stable organization and which, under the laws of the other jurisdiction, does not constitute a stable organization. [126]

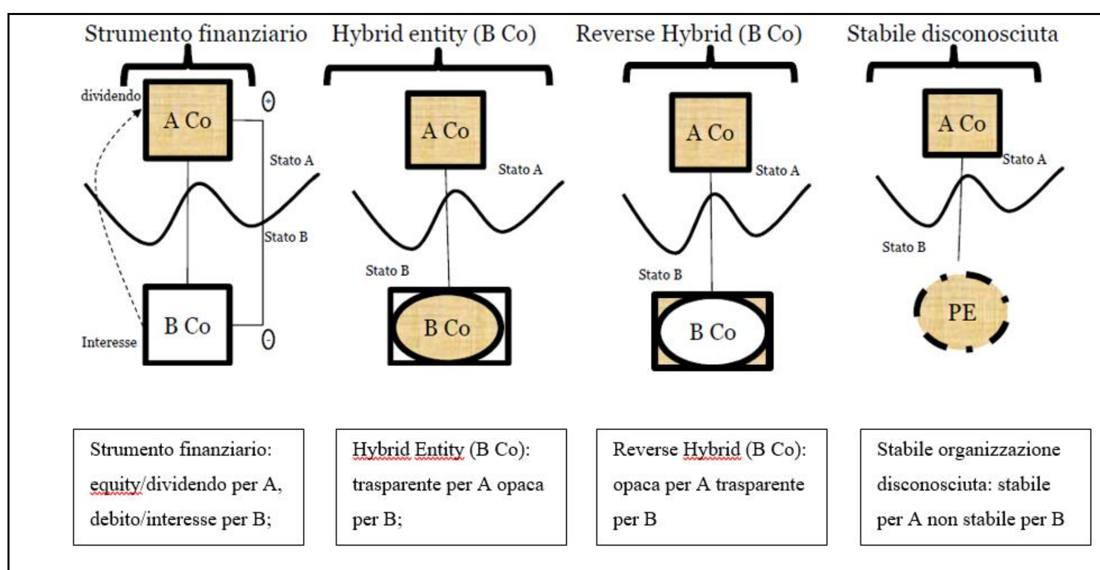

Table 2: Hybrids Players

It looks indeed clear the aim of these elements. They are, therefore, international schemes aimed at obtaining tax savings through aggressive tax planning, which exploit the disparity of

[124] Article 6, comma 1, letter l), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

[125] Article 6, comma 1, letter i), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

[126] Article 6, comma 1, letter p), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

the legislation involved. To avoid the proliferation of these harmful tax practices, the international community has intervened with tax and regulatory projects, such as the European Directive and the Base Erosion and Profit Sharing, with the aim of providing aid and answers to a fiscal phenomenon that generates the erosion of the tax base.

It is therefore necessary to mention the Base Erosion and Profit Shifting (BEPS) project of the Organization for Economic Cooperation and Development (OECD), which studies the aforementioned tax problems and reflects the thinking of the international community trying to answer and solve the perennial problem of fiscal erosion. To arrive at a practical and effective solution to the OECD had to work on domestic law and international treaties.

The ATAD 1 directive does not contain specific measures aimed at counteracting the hybrid mismatches deriving from the interaction between the regimes of companies belonging to Member States. However, there is a clear reference to a future project in which the aim is to implement a directive at a European level. It is, hence, mandatory to establish rules aimed at neutralizing the hybrids mismatches in a manner that is as comprehensive as possible. Considering that the Directive (EU) 2016/1164 governs only the hybrids mismatches derivatives from the interaction between the taxation systems of member state companies, on 12 July 2016 the Ecofin Council issued a statement in which it asked the Commission to advance , by October 2016, a proposal on hybrid mismatches involving third countries.[127]

This reference to a future deepening of the discipline of hybrid misalignments has become reality thanks to the new ATAD 2 regulation (EU Directive 2017/952 of the Council of 29 May 2017) as duly discussed by Balco T. in his work. [128] With this new directive, the anti-hybrid measures previously provided for in Directive (EU) 2016/1164 are then implemented into the European Union Legislation.

The Directive (EU) 2016/1164 includes rules on hybrid mismatches between Member States. Therefore, it should include also rules in relation to third part countries, if at least one of the parties involved is a legal person subject to corporate tax or, in the case of inverse hybrids, an entity in a Member State, as well as rules on imported mismatches. Consequently, following

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[127] Considerando n.5 della Direttiva (UE) 2017/952 del Consiglio del 29 maggio 2017;

[128] Balco T., ATAD 2: Anti-Tax Avoidance Directive, European taxation. - Amsterdam. - Vol. 57 (2017), no. 4 ; p. 127-136, 2017;

the drafting of Directive 2017/952, the rules on hybrid mismatches and on tax residence mismatches should apply to all taxpayers subject to corporate taxation in a Member State, including to permanent establishments, or to agreements treated as permanent establishments of entities resident in third part countries. The rules on reverse hybrids mismatches should apply to all entities treated as transparent for tax purposes by a Member State. [129]

In implementing this Directive, Member States should make use of the explanations and applicable examples reported in the OECD BEPS report on Action 2, both as an illustrative or interpretative source, to the extent that they are consistent with the provisions of the this European Directive and with the Union law. [130]

Therefore, the principles that report the "Actions" of the BEPS project regarding hybrid mismatches are of central importance for the description and understanding of the provisions of the European Directive (EU) 2016/1164 and, equally, have a crucial importance regarding the interpretation of the provisions of the new decree, ATAD 2.

The aforementioned decree, as mentioned above, has implemented the previous one with some measures called "**anti-hybrid**". These measures point at countering the effects of double deduction or deduction without inclusion resulting from conflicts in the classification of financial instruments, payments, entities, permanent establishments or the allocation of payments. The collection of a credit not due, for foreign taxes, born from having exploited a situation of misalignment of financial instruments (hybrid mismatches) is also object of contrast.

Since hybrid mismatches could lead to double deduction or deduction without inclusion, it is necessary to establish rules according to which the Member State concerned denies the deduction of a payment (expenses or losses) or requires the tax payer to include the payment in his taxable income, depending on the case. These rules, however, apply only to deductible payments and should not affect the general characteristics of a tax regime, whether it is a classic system or an imputation system. [131]

[129] Considerando n.8 della Direttiva (UE) 2017/952 del Consiglio del 29 maggio 2017;

[130] Considerando n.28 della Direttiva (UE) 2017/952 del Consiglio del 29 maggio 2017;

[131] Considerando n.9 della Direttiva (UE) 2017/952 del Consiglio del 29 maggio 2017;

The effects of this double deduction, or deduction without inclusion, are not the potential ones, but those that actually occur. The aforementioned provisions therefore operate when a double taxation or a deduction without inclusion is actually carried out. The term double taxation indicates the simultaneous deduction, deriving from countries with different jurisdiction, from a negative component of income that has offset a positive component of income that is not a double inclusion. On the other hand, the concept of deduction without inclusion indicates an effective deduction, in a particular jurisdiction, of a negative component of income that has balanced an income not with double inclusion. These mismatches are those that arise in a transnational context.

In the new directive, Hybrids Mismatch also concerns permanent establishments residing outside the European Union. A misalignment from hybrid permanent establishments occurs when differences between the rules of the jurisdiction of the permanent establishment and the rules of the jurisdiction of residence, regarding the allocation of income and expenses between different parties of the same entity, generate a misalignment in the fiscal results. This includes the cases in which a misalignment occurs because a permanent establishment is not recognized as such under the laws of the jurisdiction in which the fixed place of business is located. Such misalignments could result in a double deduction or a deduction without inclusion and should therefore be eliminated. In the case of a permanent disclaimed establishment, the Member State in which the taxpayer resides should include the income that would otherwise be allocated to the permanent establishment. [132]

In the new European Directive are addressed only those cases where there is a substantial risk of tax avoidance through hybrid mismatches The misalignments that in particular derive from the hybrid nature of the entities should be addressed only if one of the associated companies has at least effective control over the other associated companies. Consequently, in such cases it should be required that an associated company be owned or held by the contributing company or another associated company through participation in terms of voting rights, ownership of capital or title to receive profits of at least 50%. To apply this requirement, the ownership or rights of the people acting jointly should be aggregated. [133]

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[132] Considerando n.10 della Direttiva (UE) 2017/952 del Consiglio del 29 maggio 2017;

[133] Considerando n.13 della Direttiva (UE) 2017/952 del Consiglio del 29 maggio 2017;

4.3 - Hybrid Mismatches through the Legislative Decree November 29 2018 n. 142

The new European Directive (EU) 2017/952 May 29th 2017 has focused mainly, and therefore deeply) on hybrids mismatches. Compared to the previous Directive (EU) 2016/1164, the concept of hybrids mismatches has not only been described more precisely, but has become the scope of the new directive. Especially thanks to the enactment of Legislative Decree 29 November 2018 n. 142, we tried to clarify the issue of hybrid mismatches, but not only that. By means of the precise analysis of several articles of the aforementioned Decree, we will describe what are called "Hybrid Mismatches" through the Italian Legislative Decree.

Article 6 of the new Decree provides some crucial definitions for the description and application of the anti-hybrid provisions.
In letter a) of paragraph 1, art. 6, the new directive provides a definition of the term "mismatch" as a result of a double deduction or a deduction without inclusion. In this Legislative Decree are highlighted some definitions, not present in the European Directive 2016/1164, which I believe will be fundamental to report in order to understand the topic of hybrid mismatches, but also to contextualize all the changes made by the European Directive (EU) 2017/952 of May 29th 2017.

The concept of "deduction" defined by letter d) is the amount considered deductible for income tax purposes in accordance with the laws of the payer's or investor's jurisdiction, while the "inclusion", letter e) of the decree it is defined as the amount taken into account for the calculation of taxable income according to the laws of the beneficiary's jurisdiction. A payment, i.e. a financial instrument, is not considered included, to the extent that the payment is eligible for tax relief, only for the way in which the payment is qualified under the laws of the beneficiary's jurisdiction. [134] Tax relief, letter f) of the aforementioned decree, is intended as an exemption from taxes or a reduction in the tax rate or any tax credit or refund.

The Hybrids mismatch, object of this directive for which the anti-hybrid rules are applied, is expressed by a fiscal effect that can be expressed in two different ways:

- the double deduction, letter b, a deduction of the same negative income component in the jurisdiction in which it is claimed or claimed to be, i.e. the jurisdiction of the

[134] Article 6, letter e), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

payer, and in another jurisdiction, i.e. the jurisdiction of the investor. In the case of a payment by a hybrid entity or a permanent establishment, the jurisdiction of the payer is the jurisdiction in which the hybrid entity or permanent establishment is established or located; [135]

- the deduction without inclusion, the deduction of a negative income component in any jurisdiction in which it is sustained or deemed to be sustained, i.e. the jurisdiction of the payer, without the corresponding inclusion, for tax purposes, of the related positive income component in the beneficiary's different jurisdiction. The beneficiary's jurisdiction is any jurisdiction in which payment (or notional payment) is received or deemed to be received under the laws of any other jurisdiction. [136]

The anti-hybrid regulations involve the occurrence of a misalignment. This misalignment does not emerge in the case of double taxation, which is only theoretical in the abstract, i.e. where the deduction, present in both jurisdictions, weighs on a positive component of income also found in the two jurisdictions, or where the deduction detected in a jurisdiction indicates on an income detected in both jurisdictions involved. Therefore, the concept of "double inclusion income" defined by letter g) becomes relevant as any element of income included under the laws of both jurisdictions in which the misalignment occurred. [137]

The presence of a double-inclusion income of an entity equal to or greater than the relevant deduction, excludes in concrete the emergence of the misalignment. If, on the other hand, double taxation is lower than the relevant deduction, the misalignment must be reduced accordingly.
The anti-hybrid regulations of the legislation we are studying have the scope of neutralizing the phenomena of double deduction or deduction without inclusion. The measures aimed at countering these rules do not apply if the tax effect does not emerge or is cancelled by spreading over more tax periods. Symmetrically, the anti-hybrid rules are not implemented when other regulations of the Italian legal system or of one of the foreign states involved in the transaction combat the emergence of the hybrid mismatches avoiding the occurrence of a double taxation or deduction without inclusion. The taxable income differences, attributable

[135] Article 6, letter b), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

[136] Article 6, letter c), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

[137] Article 6, letter g), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

to the valuation of the same income component made according to the rules of the individual jurisdictions involved, do not create hybrid mismatches.
With regard to the relevance of the time differences in the imputation of income, the directive provides, with reference to the deduction without inclusion, a time threshold that has a duration of 12 months from the end of the payer's tax period for those entities who could not benefit of the positive income component from the beneficiary's jurisdiction. For this reason, within the ATAD 2 Directive, there is the possibility for the taxable person, who has been denied the deduction of a negative income component, to obtain recognition providing the demonstration of the effective inclusion of the corresponding positive income component in the jurisdiction recipient's foreign currency. There may also be the case of a double deduction relating to a negative income component, accrued from a permanent establishment abroad, of a taxable person under the tax credit regime or by a non-resident subsidiary company for which the following option will proportionally include in the tax base, regardless of distribution, the income earned by all of its subsidiaries [138] not resident and falling within the definition of a company (article 133 TUIR). [139] In this hypothesis, the refusal to recognize the negative income component in a specific tax period must be taken into consideration in the event that, in one or more subsequent tax periods, this taxable person earns a taxable income through his own permanent establishment or non-resident subsidiary company for which the option discussed previously was exercised. [140] This compulsion to impose the income would be too penalizing for the taxable person and would run counter to the purposes of the Legislative Decree and the European Directive.

Therefore, the solution was to exclude from taxation the income earned by the permanent establishment or from the foreign subsidiary up to the amount of the negative income component whose deduction was denied due to the application of the provisions of the decree.

Crucial for understanding the anti-hybrid provisions are the concepts of the “Person” who is defined as "an individual or an entity" and the entity, which in the fiscal perspective and it also detected as an “autonomous taxable person” or as “transparent to tax purposes”. The

[138] Art 130 TUIR, comma 1.

[139] Art 133 TUIR, comma 1: si considerano controllate le società e gli enti di ogni tipo con o senza personalità giuridica non residenti nel territorio dello Stato le cui azioni, quote, diritti di voto e di partecipazione agli utili sono posseduti direttamente o indirettamente dalla società o ente controllante per una percentuale superiore al 50 per cento da determinarsi relativamente alla società controllante ed alle società controllate residenti.

[140] Art 130 TUIR;

concept of entity is defined in letter i) of the Legislative Decree of 29 November 2018 n.142 as any entity or agreement which, under the legislation of the State, is considered a taxable person for the purposes of income taxes and whose positive and negative income components are considered positive and negative components of income of another taxable persons under the laws of another jurisdiction.[141]

The list of subjects intended for the anti-hybrid provisions, that is, the subjects called upon to apply the aforementioned provisions aimed at neutralizing the misalignment is outlined in letter t) of the directive. The letter t) qualifies the taxable person as the companies and entities referred to Article 73, paragraph 1, letters a), b) of the TUIR, [142] as well as, the persons referred to in letter c) of the same paragraph 1, who are holders of business income, the permanent establishments in the territory of the State of companies and entities referred to in Article 73 , paragraph 1, letter d), of the TUIR, the companies with the exclusion of simple companies and subjects similar to them, as well as physical persons who carry out an entrepreneurial activity. [143]

Particular attention must be given, with reference to Article 6, letter t), to the scope of application of the anti-hybrid provisions, as they are wider than the one envisaged in the European Directive. This is due to the inclusion in the group of taxable persons of natural persons who carry out a business activity. This extension is based on the fact that the anti-abuse provisions introduced in the Italian tax system are applied to all business income holders (for example, the general anti-abuse rules dictated by Article 10-bis of the Taxpayer's Statute and the provisions on CFC, despite the fact that for them too, the ATAD directive provides for its application only to IRES subjects).

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[141] Art. 6 lettera i), DECRETO LEGISLATIVO 29 novembre 2018, n. 142,

[142] Article 73 TUIR, paragraph 1: Sono soggetti all'imposta sul reddito delle societa':

a) le societa' per azioni e in accomandita per azioni, le societa' a responsabilita' limitata, le societa' cooperative e le societa' di mutua assicurazione, nonche' le societa' europee di cui al regolamento (CE) n. 2157/2001 e le societa' cooperative europee di cui al regolamento (CE) n. 1435/2003 residenti nel territorio dello Stato;
b) gli enti pubblici e privati diversi dalle societa', nonche' i trust, residenti nel territorio dello Stato, che hanno per oggetto esclusivo o principale l'esercizio di attivita' commerciali;
c) gli enti pubblici e privati diversi dalle societa', i trust che non hanno per oggetto esclusivo o principale l'esercizio di attivita' commerciale nonche' gli organismi di investimento collettivo del risparmio, residenti nel territorio dello Stato;
d) le societa' e gli enti di ogni tipo, compresi i trust, con o senza personalita' giuridica, non residenti nel territorio dello Stato.

[143] Art. 6 lettera t), DECRETO LEGISLATIVO 29 novembre 2018, n. 142,

The operations subject to the contrast rules (anti-hybrid provisions) only concern the hybrid mismatches that arise between the head office and permanent establishment or between two or more permanent establishments of the same entity, the misalignments arise between the taxable person and its associated companies or between associated companies and those deriving from a structured agreement involving a taxable person. Transactions between associated companies or transactions included in a structured agreement report a critical risk of undue reduction of the tax base through hybrids mismatches.

We must therefore provide a precise definition of an associated company in order to continue with our study. The definition is broad and includes a) an entity in which the taxable person directly or indirectly holds a stake in terms of voting rights or capital ownership equal to or greater than 50% or has the right to receive a percentage of the profits of that entity equal to or greater than 50%; b) an individual or entity that directly or indirectly holds a stake of 50% or more in the assets of a taxable person or has the right to receive a percentage of the tax payer's profits equal to or greater than 50%; c) an entity that is part of the same consolidated group for the purposes of financial accounting of the taxable person; d) a company in which the taxable person exercises a dominant influence over the management pursuant to Article 2359 of the CC [144]; e) a company that exercises a dominant influence over the management of the taxable person pursuant to Article 2359 of the CC. [145]

The percentage of voting rights or the capital of an entity together with other parties is crucial for the purposes of the existence of the control requirement. In the case of hybrids mismatches related to financial instruments or hybrids transfers, the relevant threshold for ascertaining the existence of control is reduced to 25%.
The concept of a structured agreement therefore becomes decisive for the description and understanding of hybrid mismatches.

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[144] Articolo 2359 codice civile: *Società controllate e società collegate*. Sono considerate società controllate:
1) le società in cui un'altra società dispone della maggioranza dei voti esercitabili nell'assemblea ordinaria;
2) le società in cui un'altra società dispone di voti sufficienti per esercitare un'influenza dominante nell'assemblea ordinaria;
3) le società che sono sotto influenza dominante di un'altra società in virtù di particolari vincoli contrattuali con essa.
Ai fini dell'applicazione dei numeri 1) e 2) del primo comma si computano anche i voti spettanti a società controllate, a società fiduciarie e a persona interposta; non si computano i voti spettanti per conto di terzi.
Sono considerate collegate le società sulle quali un'altra società esercita un'influenza notevole. L'influenza si presume quando nell'assemblea ordinaria può essere esercitato almeno un quinto dei voti ovvero un decimo se la società ha azioni quotate in borsa.

[145] Art. 6 comma 1, lettera u), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

The structured agreement, letter q) article 6, paragraph 1, is defined as an agreement that determines a hybrids mismatch in which the economic impact of the misalignment is assessed in negotiating the economic-financial terms of the agreement or aimed at producing a hybrids mismatch. This is true except in the event that the taxpayer or an associated company may reasonably have not been aware of such misalignment and has not shared the value of the tax benefit resulting from the hybrids mismatches. [146] The reasonable awareness of obtaining a tax advantage from the taxpayer is sufficient to trigger the application of the anti-hybrid provisions of the Decree. In a specular manner, the innocent ignorance of the taxpayer obtaining a tax advantage is not sufficient to defuse the application of the law where it has nevertheless obtained a benefit from the social advantage.

The time has come to introduce and analyze the letter r) article 6, paragraph 1, which goes to describe in detail the concept of hybrids mismatch and the cases that give rise to the tax effects that give rise to the aforementioned conflicts.

The hybrids mismatch is a situation that involves a taxable person in which:

1. a negative income component, based on the contractual provisions governing a financial instrument or a hybrid transfer, generates a deduction without inclusion and jointly:
    1.1. the misalignment is attributable to differences in the qualification of the financial instrument or the income component based on the jurisdiction of the payer and that other than the beneficiary;
    1.2. the corresponding positive income component is not included by the beneficiary's jurisdiction in a tax period that begins within 12 months from the end of the payer's tax period with reference to which the negative income component has been deducted; [147]
2. a negative component of income sustained or deemed to be incurred based on the contractual provisions governing a financial instrument or a hybrid transfer does not generate a hybrid mismatch if the tax relief granted in the beneficiary's jurisdiction is due exclusively to the tax status of the latter or the fact that the instrument is subject to the terms of a special tax regime; [148]
3. a negative income component sustained or deemed to be incurred in favor of a hybrid entity generates a deduction effect without inclusion. The misalignment is the result of

[146] Art. 6 paragraph 1, lett. q), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

[147] Art. 6 paragraph 1, lett. r), n. 1 DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

[148] Art. 6 paragraph 1, lett. r), n. 2 DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

differences in the allocation of the corresponding positive income component in favor of the hybrid entity under the laws of the jurisdiction in which the hybrid entity is established or registered and the laws of the jurisdiction of any person with a stake in that hybrid entity. A negative component of income sustained or deemed to be incurred does not lead to a mismatch from hybrids if the deduction without inclusion would have occurred in any case due to the exemption status of the beneficiary's tax under the laws of its jurisdiction of residence or localization; [149]

4. a negative income component sustained or deemed to be sustained in favor of an entity having one or more permanent establishments generates a deduction effect without inclusion. This misalignment is the result of differences in the allocation of the corresponding positive income component under the laws of the jurisdiction of residence of the parent company and the laws of the localization jurisdiction of its permanent establishment or the laws of the localization jurisdictions of two or more permanent organizations of the same entity. In any case, a negative component of income sustained or deemed to be incurred does not lead to a hybrids mismatch if the deduction without inclusion would have occurred in any case due to the status of exemption from the tax payee's law pursuant to the laws of its jurisdiction of residence or location; [150]
5. a negative income component sustained or deemed to be incurred generates a deduction effect without inclusion after the attribution of the corresponding positive income component in favor of an unknown permanent establishment. A negative income component sustained or deemed to be incurred does not lead to an hybrid mismatch if the deduction without inclusion would have occurred in any case due to the exemption status of the beneficiary's tax under the laws of its jurisdiction of residence or localization; [151]
6. a negative income component sustained or deemed to be incurred by a hybrid entity generates a deduction without inclusion. This misalignment arises from the fact that the corresponding income component is not recognized as such based on the laws of the jurisdiction of the beneficiary. A negative component of income sustained or deemed to be incurred does not lead to a hybrid mismatch if the deduction without inclusion would have occurred in any case due to the exemption status of the beneficiary's tax under the laws of its jurisdiction of residence or localization; [152]

[149] Art. 6 paragraph 1, lett. r), n. 3 DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

[150] Art. 6 paragraph 1, lett. r), n. 4 DECRETO LEGISLATIVO 29 novembre 2018, n. 142.

[151] Art. 6 paragraph 1, lett. r), n. 5 DECRETO LEGISLATIVO 29 novembre 2018, n. 142.

[152] Art. 6 paragraph 1, lett. r), n. 6 DECRETO LEGISLATIVO 29 novembre 2018, n. 142.

7. a negative income component relating to a transaction that is deemed to have taken place between the central office and the permanent establishment or between two or more permanent establishments generates a deduction without inclusion. This misalignment arises from the fact that the corresponding positive income it is not recognized as such under the laws of the beneficiary's jurisdiction. The negative component of income relating to the notional burden does not lead to an hybrid mismatch if the deduction without inclusion would have occurred in any case due to the status of exemption from the beneficiary's tax under the laws of its jurisdiction of residence or location; [153]
8. a phenomenon of double taxation of negative income components occurs. [154]

The first type listed above (article 6, paragraph 1, letter r), number 1) describes the deduction without inclusion originated by financial instruments (i.e. any instrument that gives rise to positive income components belonging to a legal financing relationship or an investment of capital and subject to taxation according to the corresponding rules regarding the relationships of debt, capital or derivatives, according to the laws of the jurisdiction of the beneficiary or payer) and by hybrids transfers (i.e. any transfer agreement of a financial instrument in to which the underlying yield is considered, for tax purposes, to be obtained simultaneously by more than one of the parties of the agreement or whose underlying return is relevant for the determination of its remuneration). [155]

To ensure that the fiscal misalignment works and the anti-hybrid regulations of the Legislative Decree are applied, the misalignment must arise from divergences in the recognition of the financial instrument or the payment made for this reason based on the payer's jurisdiction and that of the beneficiary. If instead we focus on hybrid transfers, they can give rise to a difference in tax treatment if, as a result of a transfer agreement of a financial instrument, the underlying return is treated as a derivative. The aforementioned provisions have no effect when the tax exemption granted in the beneficiary's jurisdiction is due exclusively to the latter tax status or when the financial instrument is subject to the terms of a special tax regime.

To make the above concept more linear it is useful to give some examples. There is the case of a financial instrument defined as a debt security in the payer's jurisdiction and as a capital

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[153] Art. 6 paragraph 1, lett. r), n.7 DECRETO LEGISLATIVO 29 novembre 2018, n. 142.

[154] Art. 6 paragraph 1, lett. r), n. 8 DECRETO LEGISLATIVO 29 novembre 2018, n. 142.

[155] Art. 6 paragraph 1, lett. n), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

security in the jurisdiction of the subscriber (associated company). This difference generates a hybrid mismatch (deduction without inclusion) relevant for the purposes of the discipline.

In the case of a hybrid transfer, the conclusion of a "repurchase agreement" between associated companies can be defined differently for tax purposes based on the jurisdictions of the companies involved. The use of different approaches with respect to this transfer (formalistic approach linked to the legal ownership of the underlying security and an approach based on the economic substance of the transaction) can lead to hybrids mismatches. The result can therefore be the presence of a negative income component for the transferor and a different qualification of the corresponding positive income component.

We will now proceed with the analysis of the second case (article 6, paragraph 1, letter r), n. 3). It defines a deduction without inclusion arising from a negative income component sustained or deemed to be sustained in favor of a hybrid entity. Therefore, the different allocation of this burden in favor of a hybrid entity, based on the laws of the jurisdiction in which the hybrid entity is established or registered and the laws of the jurisdiction of any other subject with a stake in a hybrid entity, can give life to the phenomenon of deduction without imposition. The result is therefore the deduction without inclusion of the interest in the various jurisdictions involved.

Article 6, paragraph 1, letter r), n. 4, lists the cases of deduction without inclusion that arise from a negative income component sustained or that is believed to be sustained in favor of an entity having one or more permanent establishments. For example, if the positive income component is differently attributed by the jurisdiction of the permanent establishment and by that resident in the parent company, the positive income component, mirroring the negative income component, will not be subject to taxation in both states. [156]

Another type of hybrid mismatch is highlighted in Article 6, paragraph 1, letter r), n. 5 of Legislative Decree November 29th 2018, n. 142, which explains that the phenomena of deduction without inclusion may also occur in the hypothesis of deduction of a negative component of income in the jurisdiction of the payer relating to a financial flow attributed to an unknown permanent establishment. An unknown permanent establishment is defined as the exercise of an activity which, according to the jurisdiction of residence of the taxpayer, constitutes a permanent establishment and which, according to the laws of the other

[156] SENATO DELLA REPUBBLICA, “Norme contro le pratiche di elusione fiscale (direttiva ATAD 2)”, dossier 12 Settembre 2018.

jurisdictions, does not constitute a permanent establishment. [157] In this case, the neutralization of the misalignment gives the State of the parent company the obligation to include the income of the unknown permanent establishment. If in addition the State of residence of the parent company is in Italy, it will have to neutralize the hybrid mismatch by applying the tax credit system and disregarding the exemption.

Describes the cases of deduction without inclusion that originate from a negative income component sustained or that is believed to be sustained by a hybrid entity the article 6, paragraph 1, letter r, n. 6. To facilitate understanding I believe it is useful to proceed with an example. We can take the case of an entity considered as "opaque" or “transparent” for the purposes of its State of tax residence and part of a tax consolidation in that jurisdiction corresponds to an interest in favor of its shareholders established in a foreign State that treats the company as “transparent”. The interest will represent a negative income component relevant for the State of residence of the company that compensates for a non-double inclusion income. This deduction will not have to pay any inclusion of the interest to the shareholders since their state of belonging does not recognize payments between companies and members. [158]

As a new type of hybrids mismatch, the n. 7 of the letter r) of the Legislative Decree relates to the cases of deduction without inclusion that originate from a negative component of income that is believed to be sustained between the parent company and the permanent establishment or between two or more permanent establishments. [159] The aforementioned misalignment can occur as a result of different allocations of assets (e.g. intellectual property rights) in the perspective of the State of residence of the parent company and of the location of the permanent establishment or between states of resident of permanent establishment. Given the example, this different allocation can be matched by the recognition for tax purposes of a cost for the use of this intellectual property right which does not correspond to the related revenue.

The double taxation phenomena just described are not considered entirely illegitimate, there are cases in which double taxation is legitimate. An example useful to report is the case in

[157] SENATO DELLA REPUBBLICA, “Norme contro le pratiche di elusione fiscale (direttiva ATAD 2)”, dossier 12 Settembre 2018.

[158] SENATO DELLA REPUBBLICA, “Norme contro le pratiche di elusione fiscale (direttiva ATAD 2)”, dossier 12 Settembre 2018.

[159] Ibidem.

which a negative component of income of the permanent establishment is also recognized in the jurisdiction of the parent company. This effect occurs whenever the branch exemption option [160] does not operate.
A branch exemption option is an optional regime introduced with Legislative Decree 147/2015 which concerns companies under Italian law that have permanent establishments (branches) abroad, which makes it possible to exclude from taxation in Italy the losses or profits (for IRES and IRAP purposes) produced by all permanent establishments of the Italian parent company present abroad, with the exception for the branches present in black list countries, whose incomes are ascribed to transparency (procedure envisaged by the CFC regulation). [161]

This mechanism makes it possible to tax the income produced in the state where the branch is located. In the absence of an option, the result of the permanent foreign establishment, both positive and negative, is ascribed by transparency to the total income of the parent company in its state of residence.
To avoid double taxation, a credit is assigned for taxation paid in the foreign country where the branch is located.
This option allows, in principle, to make Italian companies that produce and work with stable organizations abroad more competitive by eliminating the differences in taxation between Italy and the country of the branch, as it is taxed exclusively in the country abroad without discounting Italian taxation. [162]

Similarly, a positive component of income of the permanent establishment is recognized as such also in the jurisdiction of the parent company. For the sake of completeness, I will now proceed further describing an example of illegitimate double taxation. The illegitimate double taxation occurs when a negative component of income of the permanent establishment is also recognized by the jurisdiction of residence of the parent company, but, in the jurisdiction of the permanent establishment, it compensates for an income that is not double inclusion (i.e. it is not subject to taxation in the State of residence of the parent company). [163]

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[160] Art. 168 ter. of the TUIR, “Esenzione degli utili e delle perdite delle stabili organizzazioni di imprese residenti”.

[161] SENATO DELLA REPUBBLICA, “Norme contro le pratiche di elusione fiscale (direttiva ATAD 2)”, dossier 12 Settembre 2018.

[162] Ibidem.

The phenomena of double deduction, which may emerge from the double tax residence of the taxable person and from the simultaneous relevance, in the two jurisdictions of tax residence of the same income component are also relevant.
Article 7 of Legislative Decree November 29th 2018, n. 142 provides a precise definition of jurisdiction that is worth reporting. The article identifies precisely the role of the Italian State in relation to the possible following scenarios:

1. The Italian state is the State of the payer if the negative component of income is deductible for the purposes of determining the taxable income of a taxable person.
2. The Italian state is the State of the investor if the negative component of income sustained, or that is deemed to be supported, by a permanent establishment of a taxable person or by a non-resident subject is attributed to a taxable person and is deductible to the purposes of determining its taxable income.
3. The Italian state is the State of the beneficiary if the positive component of income is attributed to a taxable person based on the jurisdiction of the payer. [164]

After having dealt with the main features and the fundamental notions outlined in the Legislative Decree November 29th 2018, n. 142, we must now introduce the focus of the discussion. Article 8 of the aforementioned Decree has set itself the scope of analyzing the phenomenon of hybrids mismatch in detail, providing useful examples to understand the concept.

I consider it crucial to reproduce the whole article 8 and its related paragraphs and then proceed to the detailed analysis of the same.

1. To the extent that a hybrid mismatch leads to a double deduction, the deduction of the negative income component is denied to the taxable person if the Italian State is the State of the investor or if it is the State of the payer and the deduction of the negative income component is not denied in the State of the investor. The non-deductibility in the State of the investor must result from a declaration issued by the taxpayer residing there or localized or from other certain and precise elements.
2. To the extent that a hybrid mismatch results in a deduction without inclusion:
    a. if the Italian State is the State of the payer, the deduction of the negative income component is denied to the taxable person, unless the misalignment is neutralized in another State. The inclusion in the State of the parent company

[163] SENATO DELLA REPUBBLICA, “Norme contro le pratiche di elusione fiscale (direttiva ATAD 2)”, dossier 12 Settembre 2018.

[164] Art. 7 del DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

or in the State of localization of the permanent establishment must result from a declaration issued by the tax payer residing there or localized or from other certain and precise elements;

   b. if the Italian State is the State of the beneficiary and the deduction of the negative income component is not denied in the State of the payer, the amount of the corresponding positive income component that would otherwise generate a misalignment is taxable for the taxable person, unless the misalignment is not neutralized in another state. The non-deductibility in the State of the payer or the inclusion in the localization of the permanent establishment of the taxable person must result from a declaration issued by the tax payer residing there or localized or from other certain and precise elements;
   c. if the deduction of a negative income component has been denied to a taxable person pursuant to letter a), the subsequent inclusion, in the foreign State of residence or location of the beneficiary, of the corresponding positive component in his taxable income, in a tax period that begins beyond 12 months from the end of the taxable period of the taxable person with reference to which the deduction has been denied, gives rise to the right to the corresponding deduction of the negative income component previously not deduced.
3. The deduction of a negative income component from a taxable person is not permitted to the extent that it finances, directly or indirectly, deductible charges that generate a hybrid mismatch through a transaction or series of transactions between associated companies or part of a structured agreement. Notwithstanding what was reported in the previous period, the negative income component sustained or deemed to be supported by a taxable person is deductible if and to the extent that one of the States of residence or location of the parties involved in the transaction or series of transactions have made an equivalent adjustment with the effect of neutralizing the hybrid mismatches in question.
4. To the extent that a hybrid mismatch involves an income of a permanent establishment that is not known to a taxable resident, that income is taxable to the latter. The previous period does not apply if the provisions of a convention to avoid double taxation between the Italian State and a third country provide for the obligation to exempt the income.

5. In the case of the terms referred to in letters g-bis) and g-ter) of paragraph 1 of article 44 TUIR, [165] as well as of transactions that produce similar economic effects, having as their object bonds and similar securities or atypical securities, the credit for foreign taxes is due in an amount corresponding to the positive difference between the income to which the said credit is linked and the financial charge relating to the aforementioned transactions. [166]

A more in-depth analysis of this article can be highlighted in the following part. In paragraph 1 of the same article, in the case of the actual presence of double deduction in the context of an agreement between associated parties or in the case of a structured agreement, the denial of the deduction by the taxable person is envisaged that qualifies as an investor, or, in the event that the taxable person is the payer, the denial of the deduction by that taxable person.
Paragraph 2, on the other hand, provides for the repudiation of the deduction for the payable payer [167] or, in the event that the taxable person is the beneficiary, for the inclusion of the positive income component in the taxable base of the taxable person, [168] only in the eventuality of the actual presence of a deduction effect without inclusion in terms of agreement between associated parties or in the context of a structured agreement.
Some types of misalignments defined as imported misalignments, i.e. those that shift the effect of a hybrid mismatch between parts in third countries to the Italian State through the use of a non-hybrid instrument involving a taxable person, are the subject of the article 8, paragraph 3. The mentioned article disown the deduction of the positive income component relevant for the taxable person involved in the transaction. It finds application only if a hybrid mismatch actually emerges.
Paragraph 4 of Article 8 provides for a measure that involves an income of an unknown permanent establishment of a resident taxable person. As regards the taxable income, it is the responsibility of the taxable person.
Finally, to conclude the analysis of Article 8 on the subject of hybrid mismatches, we analyze paragraph 5, which provides for an arrangement aimed at reducing the tax credit in a way

[165] Art. 44, TUIR, Redditi di Capital: g-bis) i proventi derivanti da riporti e pronti contro termine su titoli e valute; g-ter) i proventi derivanti dal mutuo di titoli garantito;

[166] Art. 8, DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

[167] Art. 8, paragraph 2, lett. a), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

[168] Art. 8, paragraph 2, lett. b), DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

corresponding to the taxable net income of the specific transaction that leads to the occurrence of a foreign tax credit.

Speaking of mismatches, we can find then, in the Legislative Decree, articles 9 and 10 that define the inverse hybrid mismatches and the misalignments from tax residence. They are particular types of misalignment which specify, in the case of Article 9, [169] cases of deduction without inclusion deriving from the allocation of positive income components to entities considered transparent for the purposes of the law of the State in which the entity is located and opaque for the purposes of the law of the State of location of the subjects who hold a significant interest in the entity. This case, however, should no longer occur because, as a result of tax provisions, the income of the transparent company is imputed to their members and it is subject to taxation as the participation income. It is therefore legitimate to expect the effective inclusion of the income of the hybrid entity for income tax purposes.

Regarding the article 10, it governs measures to combat double deduction phenomena deriving from cases of double tax residence. This article is of fundamental importance as this shortcut is often used by corporate groups to circumvent the taxation of the parent company and the jurisdiction of the permanent establishment. For a completeness factor, I consider it necessary to report the text of the article, present in the Legislative Decree, and comment it later.

Article 10 of Legislative Decree 29 November 2018, n. 142 consists of three paragraphs that specify that:

1. A negative income component, supported by a taxable person who is also resident for tax purposes in another EU Member State on the basis of the internal law of that State and is considered therein resident for the purposes of the agreement to avoid double existing taxes between the Italian State and that State are not deductible if this negative income component is considered deductible in the foreign State and the deduction is not offset therein by a double inclusion income. The provision of the previous period applies as long as the mismatch is not neutralized by the other State.
2. A negative income component, bear by a taxable person who is also a resident for tax purposes in a country not belonging to the European Union, is not deductible if this negative income component is considered deductible in the third country and the deduction is not compensated by a double inclusion income. The provision in the previous period applies as long as the misalignment is not neutralized by the third country.

[169] Art. 9, DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

3. If the deduction of a negative income component has been denied to a taxable person pursuant to paragraphs 1 and 2 and the same results in a positive double-inclusion income component in a subsequent tax period, the latter is excluded from taxation up to the amount of the negative component of income whose deduction was denied pursuant to paragraphs 1 and 2. [170]

Breaking down the aforementioned article 10, we can see how, in the case of a company or entities that are fiscally resident, it is considered resident for tax purposes also in another Member State of the European Union based on the internal law of that State, the deduction negative component must be disregarded for the purposes of corporate income taxes.

In the event that the Italian State is the State of tax residence for the purposes of the agreement to avoid double taxation, the measure of contrast provided for by the Legislative Decree does not operate and the task of neutralizing the hybrids mismatches will be entrusted to the foreign State.

If instead the mismatch involves a non-EU state, the deduction of the negative component must be disregarded for the purposes of income taxes.

4.4 - Hybrid Instruments and Hybrid Entities

After describing in details the concept of hybrid mismatches through the two European Directive and the Legislative Decree, the following paragraphs will have to aim to analyze two important and critical "actors" of hybrid mismatches.

The hybrid mismatch arrangements can be divided into the following two categories based on the particular hybrid technique that produces the tax outcome:

Hybrid instruments exploit a conflict in the tax treatment of an instrument in two or more countries. These arrangements can use:

- Hybrid financial instruments, under which taxpayers take mutually incompatible positions regarding the treatment of the same payment under the instrument;
- Hybrid transfers, under which taxpayers take mutually incompatible positions regarding who has the ownership rights of an asset;
- Substitute payments, under which a taxable payment in effect becomes non-taxable by virtue of a transfer of the instrument giving rise to it. [171]

[170] Art. 10, DECRETO LEGISLATIVO 29 novembre 2018, n. 142;

[171] OECD/G20, Base Erosion and Profit Shifting, "Neutralising the Effects of Hybrid Mismatch Arrangements", Action 2, 2014 Interim Report.

Hybrid entities exploit a difference in the tax treatment of an entity in two or more countries (generally a conflict between transparency and opacity). [172]

4.4.1 - Hybrid Financial Instruments

Hybrid instruments are typically instruments treated as debt in one country and as equity in another. To be more specific a hybrid financial instrument is defined as a financial instrument that is considered debt in country A where a payment on the instrument is tax deductible, while in country B the instrument is treated as equity and the proceeds constitute a tax-exempt dividend. The taxation of hybrid instruments became of massive importance as it created possibilities for development of schemes inside cross-border groups, which are somewhere in between of tax avoidance and tax evasion. [173] The critical issue arises from the complexity of these instruments, having both equity and debt features. Definition and classification of hybrid instruments varies from different studies, but we can say that are instruments that can combine elements of equity and debt. Emerson in his study gives a full list of different types of hybrid financial instruments. [174] These combinations of features is critical to understand the aim of these instruments. Both equity and debt are source of financing business, but the first one is connected to ownership and the second is not. This specific difference is the result of different ways of treatment of related income or expense by income tax, so in the case of hybrid instruments we have inevitably issues in taxation as classification of instruments could implicit differ in tax regime. To be completely clear, all legislation separate taxation of dividends and interest. Taxation of dividends and interest is associated with a certain set of tax mechanism; particularly double taxation avoiding, participation exemptions, withholding tax, taxable income, deductible expenses, thin capitalization rule. Part of these mechanisms have the aim of protecting the country of resident from profit transfer to other countries or tax evasion, another part is oriented to provide tax benefits for local businesses or foreign context. In case of hybrid financial instruments, another important issue is accounting standards. Many countries have their own, local GAAP, which more or less are in line and do not differ too much from IAS/IFRS for the most simple everyday transactions, but could have important

[172] OECD/G20, Base Erosion and Profit Shifting, “Neutralising the Effects of Hybrid Mismatch Arrangements”, Action 2, 2015 Final Report.

[173] Johannesen N., Journal of Public Economics 112 (2014) 40–52.

[174] Emerson, R., Hybrid Financial Instruments, Tax planning international review. - London. - Vol. 16 (1989), no. 9 ; p. 3-7, 1989

differences in case of more complicated issues, including accounting of hybrid instruments. [175] Local accounting principles are important for taxation of hybrid instruments, as reporting usually is connected to financial reporting, for example in case of income recognition.
The difficulties in understanding deeply the meaning and the use of these hybrid instruments, differences in financial reporting and taxation among countries are the main causes for tax avoidance and evasion.

In most of the cases, taxation of dividends and interest is well regulated. The main problem with taxation of dividends is of economic nature. [176] It is widely recognized that double taxation, for example as source of taxation in country resident and as income in country receiving dividends cannot be accepted from an economic point of view, as the same profit will be taxed twice. Therefore some additional mechanisms were developed; namely the mechanism of participation exemption. The participation exemption is a mechanism where, under certain criteria usually a level of control and period of investment held taxation of dividends is eliminated. The participation exemption mechanism is one of the most important mechanisms ensuring free capital movement in cross-border structures. [177]
Taxation of interest also has a sound economic background. [178] It is recognized that needs of business development create demand in financing sources, so interest is considered as regular business expense and therefore should be tax deductible.
Mentioning the general principles of taxation of dividends, interest in fact became classic theoretical cornerstones of economics, finance and taxation. In practice, many distortions in applications of these principles became obvious, as there are still big differences in tax rates and tax regulations among countries worldwide. Reaction to such distortions was the development of additional protective taxation mechanisms as withholding tax and thin capitalization rule.
The main goal of withholding tax and the thin capitalization rule is to protect the country resident from transfer of profit trough interest to other jurisdictions by reducing taxation of profit in the resident country. [179]

[175] Borisas S., Taxation of Hybrid Instruments, in 20th International Scientific Conference Economics and Management, 2015, pag 300.

[176] Borisas S., Taxation of Hybrid Instruments, in 20th International Scientific Conference Economics and Management, 2015, pag 300.

[177] Borisas S., Taxation of Hybrid Instruments, in 20th International Scientific Conference Economics and Management, 2015, pag 301.

[178] Ibidem.

Combination of general principles of taxation with protective tax mechanism created a very complicated multilayer taxation structure, in which the resident country for some other legislations recognizes interest exemption and for others does not, or for some countries applies withholding tax and for others does not. The overall picture becomes even more complicated because of the application of cross-border double taxation avoiding treaties. [180]
The development of hybrid instruments made cross-border taxation system even more complicated. [181] It is agreed that hybrid instruments have features both of equity and debt. [182] This simple fact theoretically creates some additional distortion to the taxation system as proceeds from the same instrument could be dividends on interest. [183] Current practice of hybrid instruments developed such complicated structures[184] that sometimes the board of experts expires difficulties in their recognition and proper classification. If we put hybrid instruments in a multilayer taxation system briefly described above, there is a possibility that, from the same hybrid instruments in one country can be recognized as dividends and as interest in another one. [185] As approaches for taxation of dividends or interests are different, conflict in recognition may result in additional benefits for cross-border structure using such instruments.
The most controversial scenario in case of hybrid instrument in cross-border structure will arise when in one country it is recognized as pure debt and in another as pure equity. [186] If there is no withholding tax between countries and the participation exemption mechanism exists in the resident country, proceeds from hybrid instrument could be treated as interest and therefore are fully tax deductible and in another country proceeds could be treated as

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[179] Borisas S., Taxation of Hybrid Instruments, in 20th International Scientific Conference Economics and Management, 2015, pag 301.

[180] Ibidem.

[181] Harris, P., "Neutralizing Effects of Hybrid Mismatch Arrangements". Papers on Selected Topics in Protecting the Tax Base of Developing Countries. United Nations Department of Economic and Social Affairs, United Nations Secretariat. New York. 2014.

[182] Borisas S., Taxation of Hybrid Instruments, in 20th International Scientific Conference Economics and Management, 2015, pag. 301.

[183] Wood, R. (1999). The Taxation of Debt, Equity, and Hybrid Arrangements. Canadian tax journal, 6, 49-80.

[184] Murata, M., Innovative cross-border financing techniques, Asia-Pacific tax bulletin. - Amsterdam. - Vol. 2 (1996), no. 7 ; p. 209-211, 1996;

[185] KPMG, The use of hybrid financial instruments in cross-border transactions : tax considerations, Amsterdam, 1990;

[186] Borisas S., Taxation of Hybrid Instruments, in 20th International Scientific Conference Economics and Management, 2015, pag. 301.

dividends and are non-taxable income. [187] Under such scenario, cross border structure will receive additional benefits, as income the tax required to be paid in the resident country will be lower.

The paradox of such a controversial scenario is a requirement of rather developed taxation system with free cross border flows of capital, which are mostly features of well-developed economies. [188] The *condition sine qua non* of these instruments are an exemption from work participation and an absence of withholding tax. Bilateral or multilateral international treaties can usually create these preconditions. Another important precondition is the existence of differences in recognition of hybrid instruments by local GAAP that is still quite often a feature of well-developed economies.[189] In case of less developed economies, the possibility of such a scenario is very low because of application of withholding tax and even double taxation of profit. As a conclusion, the problems with taxation of hybrid instruments could be detected as a non-positive side effect of efforts to guarantee non-payment cross-border export and import of capital.

While hybrid financial instruments may combine characteristics of debt and equity in any number of ways, tax systems generally categorize all such instruments as either debt or equity. Just as tax rules vary between countries in other respects, there is considerable variation in the rules that demarcate debt and equity. In the US, for example, the demarcation rules takes into account many different characteristics of the instrument, for instance whether it has fixed maturity, whether its return represents a legally enforceable claim, whether such a claim is subordinate to the claims of general creditors, and whether its holder has voting rights. [190] In other countries, demarcation rules are completely different. Under Dutch tax law, remuneration for debt (interest) is generally deductible, while remuneration for equity (profit distribution) is not deductible. Both interest and profit distributions are taxable in the hands of the recipient. Dutch corporate tax law provides for an exemption, by means of the participation exemption (*deelnemingsvrijstelling*), of income derived from equity investments

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[187] Borisas S., Taxation of Hybrid Instruments, in 20th International Scientific Conference Economics and Management, 2015, pag. 301.

[188] HM Treasury, HM Revenue&Customs. (2014).Tackling aggressive tax planning: implementing the agreed G20 OECD approach for addressing hybrid mismatch arrangements. HM Treasury, HM Revenue&Customs, UK.

[189] Borisas S., Taxation of Hybrid Instruments, in 20th International Scientific Conference Economics and Management, 2015, pag. 301.

[190] Johannesen N., Journal of Public Economics 112 (2014) 40–52

in a subsidiary if a shareholder owns at least 5% of the nominal paid-in share capital in the subsidiary and if the shares are not held as a portfolio investment. [191] In France, for instance, the classification of a financial instrument as debt or equity depends solely on whether voting rights are conferred on the holder or not. [192]

Because of such differences in the categorization of these hybrid instruments the possibility that the same financial instruments is categorized as debt in one country and equity in another country has been considered. For instance, a perpetual loan is treated as equity in some countries with reference to the equity-like characteristics that the principal is never reimbursed and as debt is other countries with reference to the debt-like characteristics that holders have no voting tights and do not fully share the risk of the business venture. Such cross-border hybrid instruments represent an important tax planning opportunity for multinational firms. [193]

To actually take a look of what we are discussing we should consider a firm that invests in a foreign subsidiary with a hybrid instrument treated as debt in the host country and equity in the home country. The payment on the instrument is treated as tax-deductible interest expenses in the host country and equity in the home country. [194]

Quantifying the use of cross-border hybrid instruments is extremely challenging because the tax treatment of financial instruments cannot be inferred from financial statements. Evidence however suggests that cross-border hybrid instruments are widely used and have contributed significantly to the decline in effective tax rates on cross-border investment. [195]

The feasibility of tax-avoidance with cross-border hybrid instruments can be measured with a method than will be analyze as follows. At the hearth of this analysis there is a simple model of hybrid instruments and their classification for tax purposes. The model posits that demarcation rules have two components: an assessment function that translates the characteristics of financial instruments into a measure of equityness and a threshold level of equityness. Hybrid instruments with a level of equityness above the threshold are treated as equity; those with a level of equityness below the threshold are treated as debt. To understand

[191] Gabriel van Gelder, Boudewijin Niels, 2013, Tax Treatment of Hybrid Finance Instruments.

[192] Connors, P. J., Woll, G. H. J., 2001. Hybrid instruments — current issues. Unpublished manuscript.

[193] Rosenbloom, H., 1999. The David R. Tillinghast Lecture: international tax arbitrage and the international tax system. Tax Law Rev. 137–166.

[194] For an in-depth analysis of distinguishing between debt and equity in domestic and international tax law, see Schön, Bakrozis, Becker et al. (2014).

[195] Johannesen N., Journal of Public Economics 112 (2014) 40–52.

how the model works, consider a perpetual loan that combines the equity-like characteristic that the principal is never reimbursed and the debt-like characteristic that the holder has no voting rights. If the assessment function puts a large weight on the maturity-dimension of financial instruments, the perpetual loan is considered relatively equity-like; if the assessment function puts a large weight on the voting-dimension, it is considered relatively debt-like. [196] Whether the perpetual loan is ultimately treated as debt or equity for tax purposes depends both on weights of the assessment function and the threshold.

Equipped with this model, the mandatory question is the following: under what conditions can firms finance foreign investment with an instrument that is treated as equity in the home country and debt in the host country? We find that for a given pair of countries with different demarcation rules, this type of tax avoidance is always feasible for firms in one of the countries and, provided that the assessment functions differ sufficiently between the two countries, it is feasible for firms in both countries. To see the intuition for this result, reconsider the U.S. tax rules that take into account many different characteristics to determine whether an instrument is debt or equity and the French tax rules that only take into account a single characteristic, voting rights. [197] If a U.S. firm finances an investment in France with an instrument that is equity-like in all dimensions except that it does not confer voting rights on the holder, the instrument is likely to be considered equity in the U.S. and debt in France. If, on the other hand, a French firm finances an investment in the U.S. with an instrument that is debt-like in all dimensions except that it confers voting rights on the holder, the instrument is likely to be considered debt in the U.S. and equity in France. Hence, in this example tax avoidance is feasible for U.S. firms investing in France as well as for French firms investing in the U.S. Clearly, the scope for avoidance derives from the two countries emphasizing different attributes of financial instruments when assessing their equityness.

This part will show and study why hybrid instruments may be an attractive tool for tax avoidance. Niels Johannesen, professor of the University of Copenhagen, in the Journal of Public Economics published an article, "*Tax avoidance with cross-border hybrid instruments*", [198] in which he developed a model that can be utilized to classify hybrid financial instruments to understand when tax avoidance with hybrids is feasible and how to treat hybrid instruments. Consider a firm investing in a foreign subsidiary and assume that the

[196] Johannesen N., Journal of Public Economics 112 (2014) 40–52.

[197] Ibidem.

[198] Ibidem.

home country operates a territorial tax system. If the investment is financed with equity, there is no tax deduction for payments on the instrument in the host country and no taxation in the home country. If the investment is instead financed with a loan (debt), the payments are tax deductible in the host country and taxable in the home country. To treat hybrid financial instruments, a dimension, an environment, must be set. An example of this dimension can be maturity: debt can have maturity of a day, a year or 100 years whereas instruments such as perpetual debt and standard equity never mature. Another example can be voting rights: in many cases all shares carry the same number of votes, but it is perfectly possible to endow shares with extra voting rights (e.g. Class A shares) or very limited voting rights (e.g. Class B Shares). Another example of dimension can be the return, which may be predetermined as in the case with a fixed interest rate loan or, to some extent, it depends on firm profits as in the case with a profit sharing loan and a loan that can be converted into equity by the holders.

Tax systems generally treat all financial instruments as either debt or equity and therefore include a rule that assign hybrid instruments to one of these categories. We posit that such a demarcation rule consists of two elements: a continuous and differentiable assessment function $F(z)$, which assigns a value to each vector z that reflects the position of the instrument on the debt-equity continuum, and a threshold level of equityness y. Under the demarcation rule $\{F(\cdot);y\}$, an instrument z is categorized as debt if $F(z)<y$ and as equity if $F(z)\geq y$. Mirroring real-world corporate tax systems, demarcation rules thus classify any financial instrument as either debt or equity. [199]

It is useful for the comprehension to see particular examples of the hybrid financial instruments. We highlighted four cases of different instruments practice.

Starting from the figure 3 a), it provides an illustration of a demarcation rule in the two-dimensional case. The shaded light blue square represents the full set of financial instruments $\mathbb{Z}$. The demarcation line depicts the subset of financial instruments. This is the set of marginal hybrid instruments with characteristics that are just sufficiently close to equity to be categorized as such by the demarcation rule. The slope of the demarcation line is negative reflecting that an increase in the equityness of a financial instrument in one dimension requires a reduction in the equityness in the other dimension to keep the overall level of equityness of the instrument constant.

We must say that, obviously, this model of hybrid financial instruments and demarcation rule is a stylized representation of reality. In the real world, the demarcation rules do not exist in

[199] Johannesen N., Journal of Public Economics 112 (2014) 40–52.

mathematical form, but are laid down on laws, regulation and jurisdiction that do not describe precisely the tax treatment of any financial instruments.

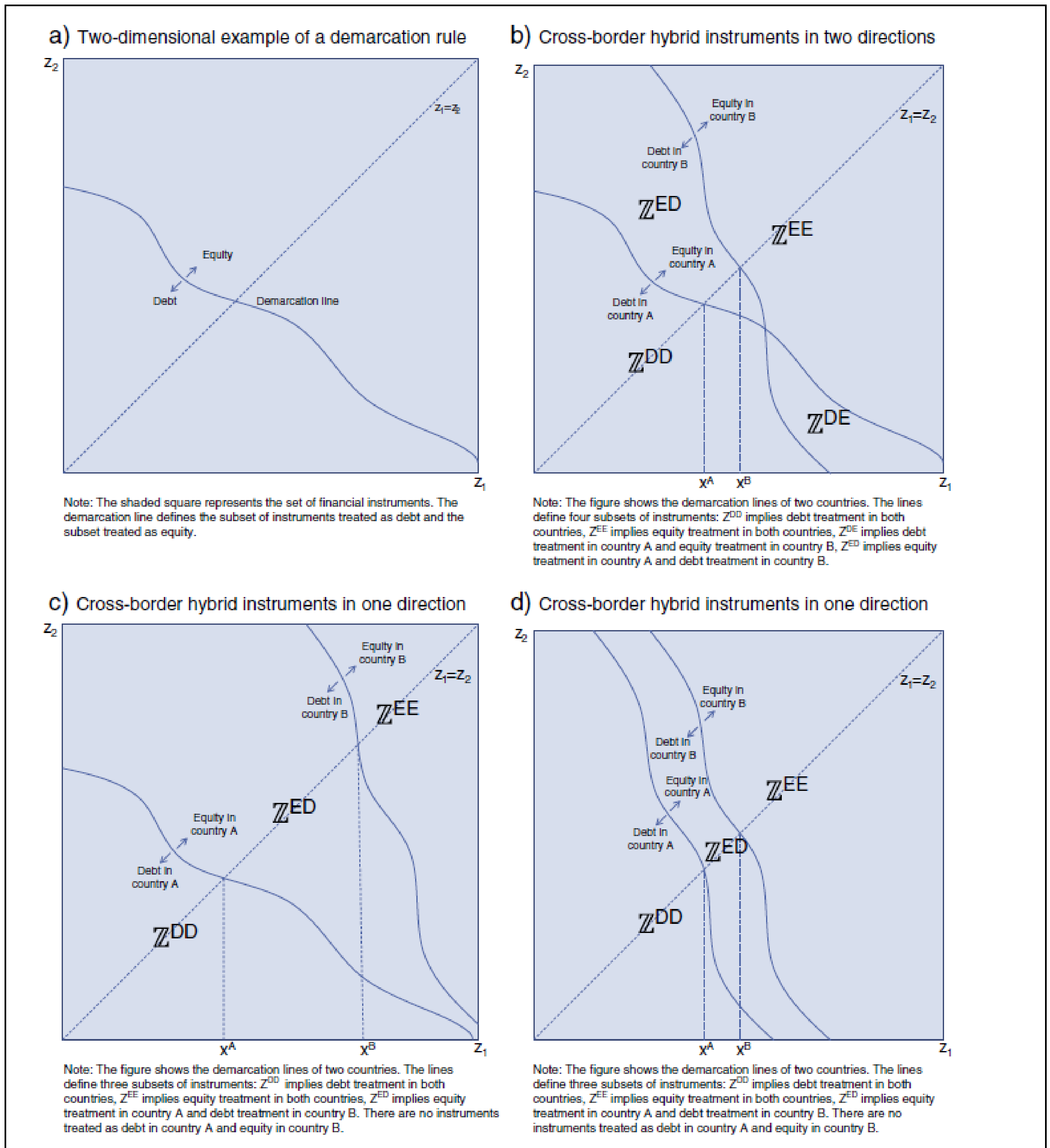

Fig. 4: Cross-border Hybrid Financial Instrument Treatment

This model, however, is still useful for understanding the tax treatment of hybrids. If, as example, identical hybrids tend to receive the same tax treatment either because the tax rules are so detailed that the correct tax treatment of an hybrid can be inferred with a little uncertainty or because the discretion of tax authorities and courts is constrained by previous

decisions, then our framework appears to be appropriate and the demarcation rule could be estimated using information about the actual tax treatment of different hybrids. On the other hand, if the tax treatment of hybrids depends on random factors, then the framework is less appropriate. [200]

Coming back the Figure 3, there are different examples of cross-border hybrid instruments. Letter b), cross-border in two directions shows the demarcation line of two countries. The two demarcation lines detect four kinds of hybrids financial instruments. Two of these are related to the letter a), $\mathbb{Z}DD$ where D refers to debt and $\mathbb{Z}EE$ where E refers to equity, which detect the same treatment for the instruments. Both countries treat the hybrid financial instrument in the same way, all debt of all equity. $\mathbb{Z}DE$ and $\mathbb{Z}ED$ describe that cases in which the two countries treat the same hybrid financial instruments in different ways. The former implies debt treatment in country A and equity treatment in country B, and the latter implies equity treatment in country A and debt treatment in country B.

Letter c), shows the demarcation line of two countries and the lines define three subset of hybrid financial instruments. $\mathbb{Z}DD$ and $\mathbb{Z}EE$ imply that both countries treat the instruments as all debt or all equity. $\mathbb{Z}ED$ instead implies equity treatment in country A and debt treatment in county B, whereas there are no cases of hybrid financial instrument for which there is a debt treatment in county A and an equity in county B ($\mathbb{Z}DE$).

Finally, letter d), shows the same demarcation lines of two countries, as shown in the other cases, but this time the two lines have the same slope, which means that are parallel and are going in one single direction. The figure 3 d) looks quite similar to letter c) in which $\mathbb{Z}ED$ implies equity treatment in country A and debt treatment in country B whereas vanishes $\mathbb{Z}DE$.

These examples suggest that, for a given pair of countries, it is generally possible to construct cross-border hybrids in one direction, either an instrument treated as equity in A and debt in B or an instrument treated as equity in B and debt in A. [201] Instead, depending on the properties of the demarcation rules, it may or may not be possible to construct cross-border hybrids in both directions, i.e. an instrument treated as equity in A and debt in B and an instrument treated as equity in B and debt in A. Moreover, the examples point to particular features of demarcation rules that appear to facilitate the use of cross-border hybrids.

Specifically, the examples suggest that more similar threshold values and less similar weights in the assessment functions make it more likely that cross-border hybrids exist in both directions. The inherent complexity around the hybrid financial instruments, as inferred from

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[200] Johannesen N., Journal of Public Economics 112 (2014) 40–52.

[201] Ibidem.

the examples above, is due to the country-specific tax environment. This point is of particular relevance upon the introduction of an effective solution that can identify all the specificities of the hybrid instruments. [202]

4.4.2 - Hybrid Transfer

Hybrid transfer, as per OECD BEPS Action 2 definition, are a particular type of collateralized loans arrangements or derivative transaction where the counterparties to the same arrangement in different jurisdictions both treat themselves as the owner of the loan collateral or subject matter of the derivative. [203] A hybrid transfer is designed to produce withholding tax relief for more than one of the parties involved. Therefore, the taxpayer Member State shall limit the relief proportion to the net table income regarding the payment.

The most common transaction used to achieve mismatch in tax outcomes under a hybrid transfer is a sale and repurchase agreement (generally referred as "repo") over an asset where the terms of the repo make it the economic equivalent of a loan. The repo results in one jurisdiction treating the arrangement in accordance with its form (a sale and a repurchase of the asset) while the counterparty jurisdiction taxes the arrangement in accordance with its economic substance (a loan with the asset serving as collateral). [204] While the collateral for these arrangements often involves shares of controlled entities, the same repo technique can be used with virtually any asset that generates an excluded or exempt return or some other tax relief under the laws of both jurisdiction. [205]

Pictured below, there is an example of collateralized repurchase agreement. The structure illustrated in Fig. 4 involves a company in Country A (A Co) which owns a subsidiary B (B Sub). A sells to shares of B Sub (or a class of shares in B Sub) to B Co under an agreement that A Co will acquire those shares at a future date for an agreed price. Between sale and repurchase, B Sub earns income, pays taxes and makes distributions on the share to B Co.

Country B, on one hand, taxes the arrangements in accordance with its form. Accordingly B Co is treated as the owner of the B Sub shares and entitled to receive and retain the dividends

[202] Djambov, F., The Hybrid Nature of Hybrid Financial Instruments and EU Steps Towards a Solution, Open Journal Maastricht University, 2016;

[203] OECD/G20 Base Erosion and Profit Sharing Project, "Neutralized effects of Hybrid Mismatch Arrangements", Action 2, 2015 Final Report;

[204] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements", Action 2, 2014 Interim Report.

[205] Vergani, M., Tax treatment of repurchase agreements, Derivatives and financial instruments. - Amsterdam. - Vol. 10 (2008), no. 2 ; p. 39-41, 2008;

paid by B Sub during the life of the repo. Country B will typically grant a credit, exclusion, exemption or some other tax relief to B Co on the dividends received. B Co also treats the transfer of the shares back to A Co as a genuine sale of shares and may exempt any gain on disposal under an equity participation exemption or a general exclusion for capital gains.

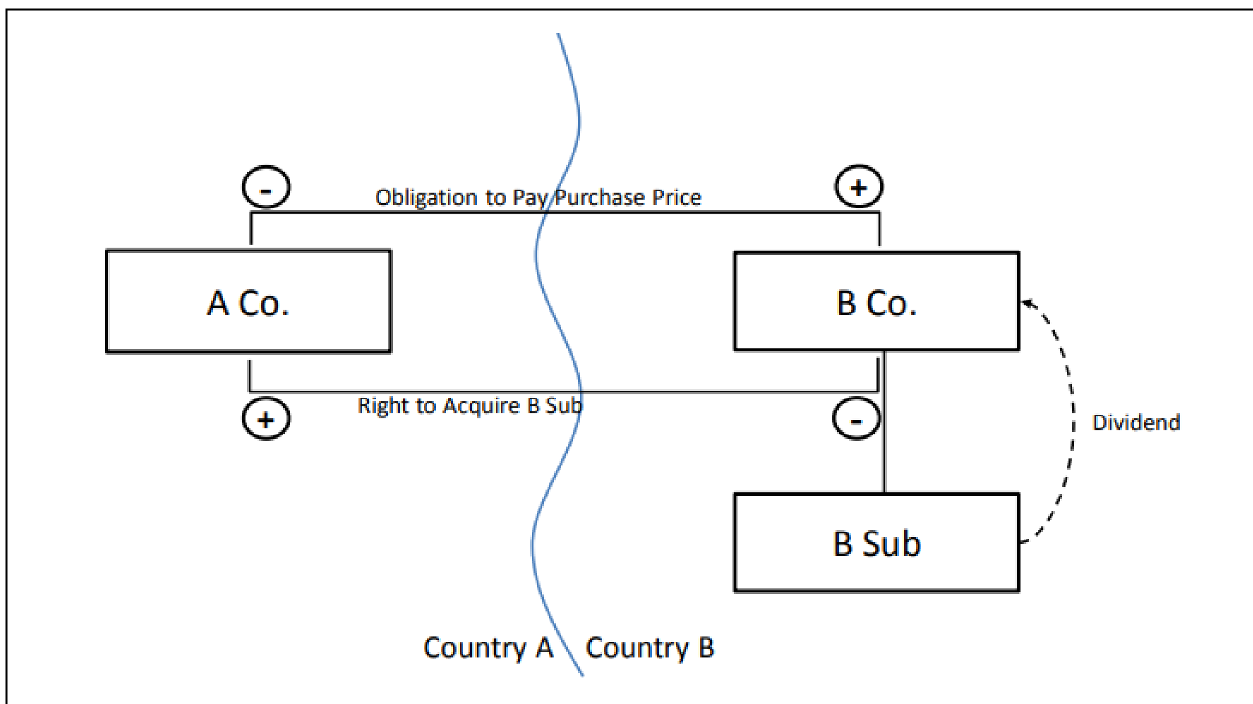

Fig. 5: Collateralized Loan Repo [206]

Country A, on the other hand, taxes the arrangement in accordance with its **economic substance**. For Country A tax purposes:

a) The transaction is treated as a loan by B Co to A Co that is secured through B Co's holding of the B Sub shares. A Co is thus regarded as being the owner of the B Sub shares with the corresponding entitlement to B Sub dividends during the life of the repo.

b) Since Country A treats A Co as the owner of B Sub shares, it requires A Co to include the amount of any dividends paid by B Sub to B Co in A Co's income. However. a credit exclusion or other tax relief applicable to those dividends will generally shelter the income tax on this dividend under the laws of Country A.

c) The net cost of the repo to A Co is treated as a deductible financing cost. This cost includes the dividends treated as economically derived by A Co that are paid to and retained by B Co from B Sub but which, for Country A purposes, are treated as paid

[206] OECD/G20, Base Erosion and Profit Shifting Project, Action 2, 2015 Final Report.

by A Co to B Co during the life of the repo. Because Country A treats A Co as having paid the amount of the dividend across to B Co, Country A grants a deduction for the amount of the dividend paid to and retained by B Co.

The net effect of this repo transaction can be illustrated below. Assume B Sub is a company that is tax resident in Country B and A Co sells the shares to B Co under a repo. The simplified calculation below assumes that B Sub holds assets worth $1,000 which generate a 10% return and that both Country A and Country B have a 30% tax rate.

	B Sub		A Co			B Co	
Net income calculation	Income	100	Dividend from B Sub	70		Dividend from B Sub	70
			Foreign tax credit	30			
			Net income		100		
			Interest paid to B Co	(70)			
Net taxable income		100			30		0
Tax at 30%		(30)		(9)			0
Foreign tax credit				30			
Country A net credit		0			21		0
Country B (net tax)		(30)			0		0

Table 3: Repo accounting treatment [207]

As illustrated in the table above, B Sub earns income of $100 and pays $30 of Country B income taxes. It then pays a dividend of $70 to B Co. A Co includes a total dividend of $100 in its taxable income (including an indirect tax credit of $30) but is able to claim a deduction of $70 for the financing expense paid to B Co. As a result, A Co has net taxable income of $30 and a total Country A tax liability of $9. A Co can, however, use the underlying tax credit to eliminate this liability and still be left with a further $21 of surplus credits to offset against tax on other income.

[207] OCED/G20 Base Erosion and Profit Shifting Project, Action 2, 2015 Final Report, Summaries of the Report.

4.4.3 - Substitute Payments

A substitute payment is any payment, made under an arrangement to transfer a financial instrument, to the extent it includes, or is a payment of an amount representing a financing or equity return on the underlying financial instrument where the payment or return would:

- not have been included in ordinary income of the payer;
- have been included in ordinary income of the payee; or
- have given rise to hybrid mismatch;

if it had been made directly under the financial instrument. [208]

Substitute payments are transfers of financial instruments where the payment of a financing or equity return under that asset transfer gives rise to a D/NI outcome that has the effect of undermining the integrity of the hybrid financial instrument rules. The transfer will have this effect where:

a) the transferor secures a better tax outcome on the payment under the asset transfer than it would have obtained if it had held onto the underlying instrument;
b) the transferee treats the payment under the asset transfer as deductible while the return on the underlying instrument will be treated as exempt or excluded from income;
c) the transfer has the effect of taking instrument outside of the scope of the hybrid financial instrument rule.

The substitute payments rule neutralizes any D/NI outcome in respect of the payment of a financing or equity return under asset transfer agreement when the transfer of the underlying financial instrument would give rise to one of the above outcomes.

Under this rule a taxpayer that buys a financial instrument for a consideration that includes a financing or equity return, will be denied a deduction for the payment if: that return would have been included in ordinary income of the payee or would not have been included in ordinary income of the payer or would have given rise to hybrid mismatch if it had been made directly under the financial instrument.

The substitute payment rules apply to any type of D/NI outcome (regardless of whether such outcome is attributable to the terms of the instrument, the tax status of the parties or the context in which the asset is held). The rule is, however, confined to payments that give rise to a financing or equity return in respect of the underlying instrument. It would not ordinarily

[208] OECD/G20 Base Erosion and Profit Sharing Project, Action 2, 2015 Final Report;

apply, for example, to a payment made to settle a claim for a breach of warranty under an asset sale agreement.

D/NI outcomes, in respect of substitute payment, refer to the substitute payment rules that is applied to any actual mismatch in tax outcomes, regardless of the circumstances in which the deduction arises. This include any amount taken into account in calculating the gain or loss on disposal of a trading asset.

Substitute payments are arrangements involving the transfer of financial instruments where a payment is made in substitution for the financing or equity return on the transferred asset and differences between the tax treatment of that payment and the underlying return on the instrument have the net-effect of undermining the integrity of the hybrid financial instrument rule. [209]
A substitute payment that gives rise to a D/NI outcome will be subject to adjustment under the hybrid financial instrument rule if the underlying financing or equity return on the transferred asset would otherwise have been taxable in the hands of the transferor or is treated as exempt or excluded from income in the hands of the transferee or if the transfer has the effect of taking financial instrument outside of the scope of the hybrid financial instruments.
The hybrid financial instrument rule applies to substitute payments and payments under a financial instrument to the extent those payments give rise to a D/NI outcome.[210] The substitute payment rule apply to any type of D/NI outcome regardless of how it arises.

A substitute payment may become payable if an economic owner of securities is deprived of a dividend or interest payment that would be expected to arise to it as economic owner of the asset. This may arise because the economic owner has lent the security under a repo or stock loan arrangement and expects the security to be transferred back at a later date, and during this period, an amount of interest or a dividend is paid.
If a repo or stock loan extends over the record date (the date that determines to whom the dividend or interest on the underlying instrument will be paid), the registered holder (the transferee) of the securities on that date is entitled to the interest or dividend. Commonly, under the terms of the stock lending or repo arrangement, the transferee will be required to compensate the original transferor by means of a substitute payment.

[209] OECD/G20 Base Erosion and Profit Sharing Project, Action 2, 2015 Final Report.

[210] Ibidem.

There may be a chain of substitute payments, for instance if shares are lent to an intermediary, and then on-lent to a further party who sells into the market intending to repurchase similar shares in the market at a later date.
Substitute payments are not limited to those made in stock lending and repo arrangements. For example, a company might enter into a contract to sell securities cum dividend (i.e. including the right to the dividend) but for some reason, perhaps because of a delay in delivery resulting from a failed trade, title to the securities might not pass until after the record date for the dividend or interest in question. The securities are thus delivered ex-dividend. Typically, the sales contract will require the vendor to make a substitute payment (which might be described as compensation) to the purchaser in such circumstances – thus the substitute payment is made in reverse by the transferor to the transferee. A failed delivery that gives rise to a substitute payment, whether unintended or deliberate. [211]

4.4.4 - Hybrid Entities

Some arrangements exploit differences between the transparency or opacity of an entity for tax purposes (hybrid entities) and others involve the use of hybrid instruments, which generally involve a conflict in the characterization of the instrument (and hence the tax treatment of the payments made under it). [212] Hybrid instruments and entities can also be embedded in a wider arrangement or group structure to produce indirect D/NI outcomes. An indirect D/NI outcomes is hereby explained into details. Once taxpayers have entered into a hybrid mismatch arrangement between two jurisdictions without effective hybrid mismatch rules, it is a relatively simple matter for the effect of that mismatch to be shifted into a third jurisdiction (through the use of an ordinary loan, for example). [213] Therefore, in order to protect the integrity of the recommendations, OECD recommends that a payer jurisdiction deny a deduction for a payment where the payee sets the income from that payment off against expenditure under a separate hybrid mismatch arrangement. [214]

[211] HMRC International Manual, “Hybrid and Other Mismatches”, GOV.UK, 21 May 2019.

[212] OECD/G20 Base Erosion and Profit Sharing Project, “Neutralising the Effects of Hybrid Mismatch Arrangements” Action 2, 2015 Final Report.

[213] HMRC International Manual, “Hybrid and Other Mismatches”, GOV.UK, 21 May 2019.

[214] OECD/G20 Base Erosion and Profit Sharing Project, “Neutralising the Effects of Hybrid Mismatch Arrangements” Action 2, 2015 Final Report.

In most cases, the causal connection between the hybrid element and the mismatch will be obvious. [215] There are some challenges, however, in identifying the hybrid element in the context of hybrid financial instruments. Because of the wide variety of financial instruments and the different ways jurisdictions tax them, it has proven impossible, in practice, for OECD Action 2, to comprehensively identify and accurately define all those situations where cross-border conflicts in the characterization of a payment under a financing instrument may lead to a mismatch in tax treatment. [216] Rather than targeting these technical differences, the focus of the OECD report Action 2 is on aligning the treatment of cross-border payments under a financial instrument so that amounts that are treated as a financing expense by the issuer's jurisdiction are treated as ordinary income in the holder's jurisdiction. Accordingly, OECD recommends that a financial instrument should be treated as hybrid if a payment under the instrument gives rise to a mismatch in tax outcomes and the mismatch can be attributed to the terms of the instrument. [217]

5 - Hybrid Financial Instruments Rule

[215] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements", Action 2, 2014 Interim Report.

[216] OECD/G20 Base Erosion and Profit Sharing Project, "Neutralising the Effects of Hybrid Mismatch Arrangements" Action 2, 2015 Final Report.

[217] Ibidem.

The OECD give, therefore, recommendations regarding hybrid financial instruments with the "Hybrid Financial Instrument Rule". The main goal is to neutralize the effects of mismatches that arise under hybrid financial instruments through the adoption of a linking rule that would seek to align the tax outcomes for the payer and payee under financial instruments. This rule only applies to a payment made to a related person or where the payment is made under a structured arrangement and the taxpayer is party to that structured arrangements.

In addition to the specific recommendations that we are going to highlight, the OECD Action 2 report sets out recommendations for hybrid mismatch rules that adjust the tax outcomes under a hybrid mismatch arrangement in one jurisdiction in order to align them with the tax outcomes in the other jurisdiction. These recommendations target payments under a hybrid mismatch arrangement that give rise to one of the three following outcomes:

1) Payments that give rise to a deduction/no inclusion outcome (D/NI outcome), i.e. payments that are deductible under the rules of the payer jurisdiction and are not included in the ordinary income of the payee.
2) Payments that give rise to a double deduction outcome (DD outcome), i.e. payments that give rise to two deductions in respect of the same payment.
3) Payments that give rise to an indirect D/NI outcome, i.e. payments that are deductible under the rules of the payer jurisdiction and that are set-off by the payee against a deduction under a hybrid mismatch arrangement. [218]

There are several recommendations in the OECD document, but the first one regards the hybrid financial instrument rule. These set of recommendations have the scope of avoid the events of hybrid mismatches.

The first recommendation (1) explain how to neutralize the mismatch to the extent the payment gives rise to a D/NI outcome.

This rule should apply to a payment under a financial instrument that result in a hybrid mismatch and to a substitute payment under an arrangement to transfer a financial instrument:

a) The payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/NI outcome. [219]

[218] OECD/G20 Base Erosion and Profit Sharing Project, "Neutralising the Effects of Hybrid Mismatch Arrangements" Action 2, 2015 Final Report.

[219] OECD/G20 Base Erosion and Profit Sharing Project, "Neutralising the Effects of Hybrid Mismatch Arrangements" Action 2, 2015 Final Report.

b) If the payer jurisdiction does not neutralize the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome.

c) Differences in the timing of the recognition of payments will not be treated as giving rise to a D/NI outcome for a payment made under financial instruments, provided the taxpayer can establish to the satisfaction of tax authority that the payment will be included as ordinary income within a reasonable period of time.

As a recommendation, a definition (2) of financial instrument and substitute payment has been given and for the purpose of the hybrid financial instrument rule:

a) a financial instruments means any arrangement that is taxed under the rules for taxing debt, equity or derivatives under the laws of both the payee and payer jurisdictions and includes a hybrid transfer;

b) a hybrid transfer includes any arrangements to transfer a financial instruments entered into by a taxpayer with another person where:

    i. the taxpayer is the owner of the transferred asset and the rights of the counterparty in respect of that asset are treated as obligations of the taxpayer;

    ii. under the laws of the counterparty jurisdiction, the counterparty is the owner of the transferred asset and the rights of the taxpayer in respect of that asset are treated as obligations of the counterparty.

    Ownership of an asset for these purposes includes any rules that result in the taxpayer being taxed as the owner of the corresponding cash flows from the asset.

c) A jurisdiction should treat any arrangement where one person provides a money to another in consideration for a financing or equity return as a financial instrument to the extent of such financing or equity return.

d) Any payment under an arrangement that is not treated as a financial instrument under the laws of the counterparty jurisdiction shall be treated as giving rise to a mismatch only to the extent the payment constitutes a financing or equity return. [220]

e) A substitute payment is any payment, made under an arrangement to transfer a financial instrument, to the extent it includes, or is payment of an amount representing, a financing or equity return on the underlying financial instrument where the payment or return would:

    - not have been included in ordinary income of the payer;
    - have been included in ordinary income of the payee; or

[220] OECD/G20 Base Erosion and Profit Sharing Project, "Neutralising the Effects of Hybrid Mismatch Arrangements" Action 2, 2015 Final Report, Recommendation 1.1.

- have given rise to hybrid mismatches;

if it had been directly made under the financial instruments. [221]

The mentioned hybrid financial instruments rule only applies to a payment under a financial instrument that results in a hybrid mismatches. A payment under a financial instrument results in a hybrid mismatch where the mismatch can be attributed to the terms of the instrument. [222] A payment cannot be attributes to the terms of the instrument if the mismatch is solely attributable to the status of the taxpayer or the circumstances in which the instrument is held. [223]

There are however some exceptions of this rules. The primary response in the first recommendation 1) a) should not apply to a payment by an investment vehicle that is subject to special regulation and tax treatment under the laws of the establishment jurisdiction in circumstances where:

a) the tax policy of the establishment jurisdiction is to preserve the deduction for the payment under the financial instrument to ensure that:
    - the taxpayer is subject to no or minimal taxation on its investment income;
    - those holders of financial instruments issued by the taxpayer are subject to tax on that payment as ordinary income on a current basis.
b) the regulatory and tax framework in the establishment jurisdiction has the effect that the financial instruments issued by the investment vehicle will result in all or substantially all of the taxpayer's investment income being paid and distributed to the holders of those financial instruments within a reasonable period of time after that income was derived or received by the taxpayer;
c) the tax policy of the establishment jurisdiction is that the full amount of the payment is:
    - included in the ordinary income of any person that is a payee in the establishment jurisdiction;
    - not excluded from the ordinary income of any person that is a payee under the laws of the payee jurisdiction under a treaty between the establishment jurisdiction and the payee jurisdiction.

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[221] OECD/G20 Base Erosion and Profit Sharing Project, "Neutralising the Effects of Hybrid Mismatch Arrangements" Action 2, 2015 Final Report, Recommendation 1.2.

[222] HM Treasury, HM Revenue&Customs. (2014).Tackling aggressive tax planning implementing the agreed G20 OECD approach for addressing hybrid mismatch arrangements. HM Treasury, HM Revenue&Customs, UK.

[223] OECD/G20 Base Erosion and Profit Sharing Project, "Neutralising the Effects of Hybrid Mismatch Arrangements" Action 2, 2015 Final Report, Recommendation 1.3.

d) The payment is not made under a structured arrangement. [224]

The reason behind this first recommendation is to prevent a taxpayer from entering into structured arrangements or arrangements with a related party that exploit differences in the tax treatment of a financial instrument to produce a D/NI outcome. The rule aligns the tax treatment of payments under a financial instrument by adjusting the amount of deductions allowed under the laws of the payer jurisdiction, or the amount of income to be included in the payee jurisdiction, as appropriate, in order to eliminate the mismatch in tax outcomes.

6 - Hybrid Mismatches in Italian Jurisdiction

The OECD reports 2015 and 2017 on Action 2, have set many innovations to contrast hybrid mismatches, but because of the celerity that the EU Directive has taken this innovations, not

[224] OECD/G20 Base Erosion and Profit Sharing Project, "Neutralising the Effects of Hybrid Mismatch Arrangements" Action 2, 2015 Final Report, Recommendation 1.5.

all the States in the EU have seen the proper impact of this new elements introduced by the BEPS Actions.

Focusing on the Italian prospective, the new applications in terms of detecting and contrasting hybrid mismatches seem to have been implemented without too many difficulties.

As cited before, when discussing and analyzing the Legislative Decree, the Italian legal system should be fighting the hybrid mismatches instruments correctly and more easily in comparison with other European and worldwide countries. We say "should" because not all the elements discussed and cited in the OECD report have been implemented and discussed in the Italian legal system. This is the case of substitute payments discussed in the previous paragraph. Nevertheless, the Italian legal system is working constantly studying these new instruments introduced by the OECD reports and has already commit itself to implement new transnational initiatives, thus reforming the domestic tax system.

The legislator's aim, when implementing the Italian legal system, is to pursue the capital export neutrality, thus the principle of non-discrimination. The real aim namely is to equalize the cross border fiscal effect to the Italian one. This principle is pursue through the fundamental assumption of our fiscal system which is the taxation of all products and entities of income produced everywhere (worldwide criteria), together with the tax credit method for income produced abroad if some conditions are met. The settings we have just seen is clearly more protective compared to the method of the exemption, with the aim of stopping the evasions born from hybrid mismatches, since in almost every case the foreign income it is subject however to taxation at least in the Italian State and the taxpayer will have to work to obtain the tax credit incurred cross-border. This, however, does not mean a fully protection: mismatches could arise through custom-made tax credit or because of different cross-border fiscal tax system.

Regarding hybrid mismatches in particular, an evident index of protection is given by the article 44, paragraph 2, let. a) of the TUIR, [225] which says that income from equity investment, financial instruments and securities issued by the foreign companies, if the remuneration depends completely from the investment in the economic results of the issuing companies belonging to the same group and only if the remuneration does not refer to a

[225] Art. 44, comma 2, lett. a) «Ai fini delle imposte sui redditi: a) si considerano similari alle azioni, i titoli e gli strumenti finanziari emessi da società ed enti di cui all'articolo 73, comma 1, lettere a), b) e d), la cui remunerazione è costituita totalmente dalla partecipazione ai risultati economici della società emittente o di altre società appartenenti allo stesso gruppo o dell'affare in relazione al quale i titoli e gli strumenti finanziari sono stati emessi. Le partecipazioni al capitale o al patrimonio, nonché i titoli e gli strumenti finanziari di cui al periodo precedente emessi da società ed enti di cui all'articolo 73, comma 1, lettera d), si considerano similari alle azioni a condizione che la relativa remunerazione sia totalmente indeducibile nella determinazione del reddito nello Stato estero di residenza del soggetto emittente; a tale fine l'indeducibilità deve risultare da una dichiarazione dell'emittente stesso o da altri elementi certi e precisi»

deduction in the state of the issuer, tested with a declaration of the issue itself or by certain and precise elements.

6.1 - Hybrid Mismatch: Emilia Romagna Case

There has been a case of hybrid mismatches, precisely a case of hybrid financial instruments, in the Emilia Romagna region in Italy. [226] In this occasion, the Italian tax system was able to analyze and detect a case of hybrid mismatch even if the rule and the indications in the Italian financial system are not fully detailed and understood.

The judgement concerns a case of an Italian company that had received the right to use the trademark of its American parent company, first in free concession, then based on one usufruct (for 5 years) and then again through a license contract. The Italian had subsequently licensed this distinctive sign to other companies of the same group, obtaining royalties. Thus, the resident subsidiary had first deducted the resulting costs from the usufruct and then the royalties paid to the parent company with significant consequences on income taxable for IRES purposes. What did not appear clear to the revenue agency was the variation of a management model over the years without apparent economic motivation. The deductions, according to the Italian tax system, made by the Italian subsidiary, lacked any inherent reason of the fact that, in previous years, the mark had been granted free of charge and, therefore, the group's contractual policy was exclusively aimed at eroding the taxable income in Italy and to transfer profits to another tax jurisdiction. The change in industrial strategy, according to the Italian Revenue Agency, was nothing more than an artificial allocation of an instrument from one Country to the other.

7 - Substitute Payments: OECD and ATAD 2

The hybrid financial instruments rule described in the OECD Action 2, 2015 and 2017 raise concern on the application of a particular instrument cited earlier in the thesis. In the 2015 and 2017 BEPS report, substitute payments instruments were studied and included in the Actions,

[226] V. Commissione tributaria regionale dell’Emilia Romagna del 30 ottobre 2017, n. 2996 (Sez. IX); Commissione tributaria regionale dell’Emilia Romagna del 15 novembre 2017, n. 3092 (Sez. IX).

but their meaning and power were not fully understood by the actors in play. In fact, this may be one of the reason why these substitute payments were not incorporated in the last Council Directive (EU) 2017/952 of 29 May 2017. The job of this chapter will be analyzing the substitute payments under the European and Italian jurisdiction and compare them with substitute payments in a cross-border jurisdiction outside European Union. I will then try to give a brief explanation on why these instruments were not included in the ATAD 2 Directive and included instead in the OECD reports.

7.1 - Substitute Payment in Italy and in the EU Jurisdiction

The real question to ask is the following. Why this crucial financial instrument capable of contrasting the hybrid mismatches is not present in the Anti-Tax Avoidance Directive? Why the European legislators have decided not to include these instruments?

In the OECD reports, substitute payments are defined as the "last chance" to contrast hybrid mismatches. The substitute payments are instruments used for the closing procedure. Their scope is to grant the integrity of anti-hybrid rule on hybrid financial instruments. Usually a company utilize substitute payments when the first two instruments given in the hybrid financial instruments rule, hybrid financial instruments and hybrid transfer, are not successful in treating and avoiding hybrid mismatches. This is clear in the OECD reports (2015 and 2017), but it seems not in the Anti-Tax Avoidance Directive.

What are the possible reason why this powerful instrument is not present in the ATAD? It could be difficult to explain the exact reason, because we cannot put ourselves in the shoes of the legislators who implemented the Anti-Tax Avoidance Directive. We can however list and analyze some reasons, based on the difference between the OECD reports and the EU legislation directive.

For instance, since substitute payments are used mostly outside the European Union such as in Australia, New Zealand and USA it is probably too complicated to adapt to the EU model, for now, either because it is too difficult to implement in the European "environment", either because the European Union is not ready for this kind of new instrument.

Another reason worth bring to light is that the legislators, who implemented the Anti-Tax Avoidance Directive, did not fully understand the usage of this instrument in the EU directive. Worldwide taxation rules are quite different from each other; this means that, to implement a complete new rule and a new instrument in the European Union, there must be a whole study

behind the innovative instruments. Differences of treatment between European Union and Extra European Union it is certainly a concrete reason why the EU Directive did not take into consideration the substitute payment as indicator to detect and stem hybrid mismatches.

The OECD gave a definition of these instruments, but, compared to the other hybrid instruments listed in both Action 2 2015 and 2017, i.e. hybrid financial instruments and hybrid transfer, there are too few examples to permit the comprehension. To allow a financial instrument to be implemented into a worldwide and/or European Directive, clarification must be a critical and a focal point to consider. This is also to be considered as reason why substitute payments are not in the directive.

The reason to adopt this new discipline in the European Union and therefore also in Italy, could have a more political or of international taxation instead of an actual need. Given the need of integration and fiscal cooperation that are critical to avoid the huge loss of resources, the use of a common language and the externalization of the manifest intention of an adjustment to international standards by our country can have an attractive function for the investor, the tax legal systems and States in general. Can also have a defensive function with respect to the creation of structure based on aggressive tax planning, for this reason it should be pointless to adopt different instruments based on different tax legal system (i.e. substitute payments), and to prevent one or more countries to use and benefit from this.

Among the possible reasons that can lead to avoiding this last problem, there is a consideration of the global scope of the project, and the fact that, based on the structure of the devised norms, articulated therefore in primary and secondary/defensive rules (defined precisely “linking rules”), also if there were no cooperation from certain States, it should be the implementing jurisdiction to resolve the issue of tax avoidance or "mitigation" of its amount.

The real question to ask is how the Italian jurisdiction can homologate to the OECD reports and have the same elements and instruments adopted in the tax legal system. There can be two scenarios.

The first one can be a new specific regulation, created ad hoc, in order to reach out the European Directive article 9. That can be a single paragraph added in the Directive or in the TUIR (Art. 44, TUIR). This one can also be the riskier one, because the legislator could put at risk and damage the actual Italian legal system caused by the amendment of the article. The second scenario is constituted by the “reasoned” implementation of the precise and only provisions that would be able to intercept all of those cases from which out tax legal system does not provide adequate protection.

To support this thesis it is now ongoing new additional studies on different elements, including the substitute payment discipline, that are going to update the European directive in the following months.

7.2 - Substitute Payments Cross-Border in OECD Report

In the previous chapters, we gave a brief description on substitute payments, taken by the OECD Report, and now we are going more into details and the aim will be to analyze these instruments through examples.

To increase the comprehension of these financial instruments it is crucial to give several examples with consequent analysis of the case.

Example 1.30, Example 1.35, and Example 1.36 explain the application of the hybrid financial instrument rule to substitute payments. In Example 1.30, the hybrid financial instrument rule is applied to a purchase price adjustment under a share sale agreement where differences between the tax treatment of dividends and sale consideration in the payee/transferor jurisdiction allow the payee/transferor to substitute what would otherwise have been a taxable dividend for a non-taxable exchange gain.

Example 1.35 illustrates how the substitute payment definition prevents a payer/transferee manufacturing a deduction for a payment under an asset transfer agreement when the transferee has no economic loss.

Example 1.36 describes a situation where the transfer of a financial instrument takes the instrument outside the scope of the hybrid financial instrument rule. In that example the substitute payment definition will apply to adjust the tax consequences for the parties to the transfer to neutralize any mismatch in tax outcomes.

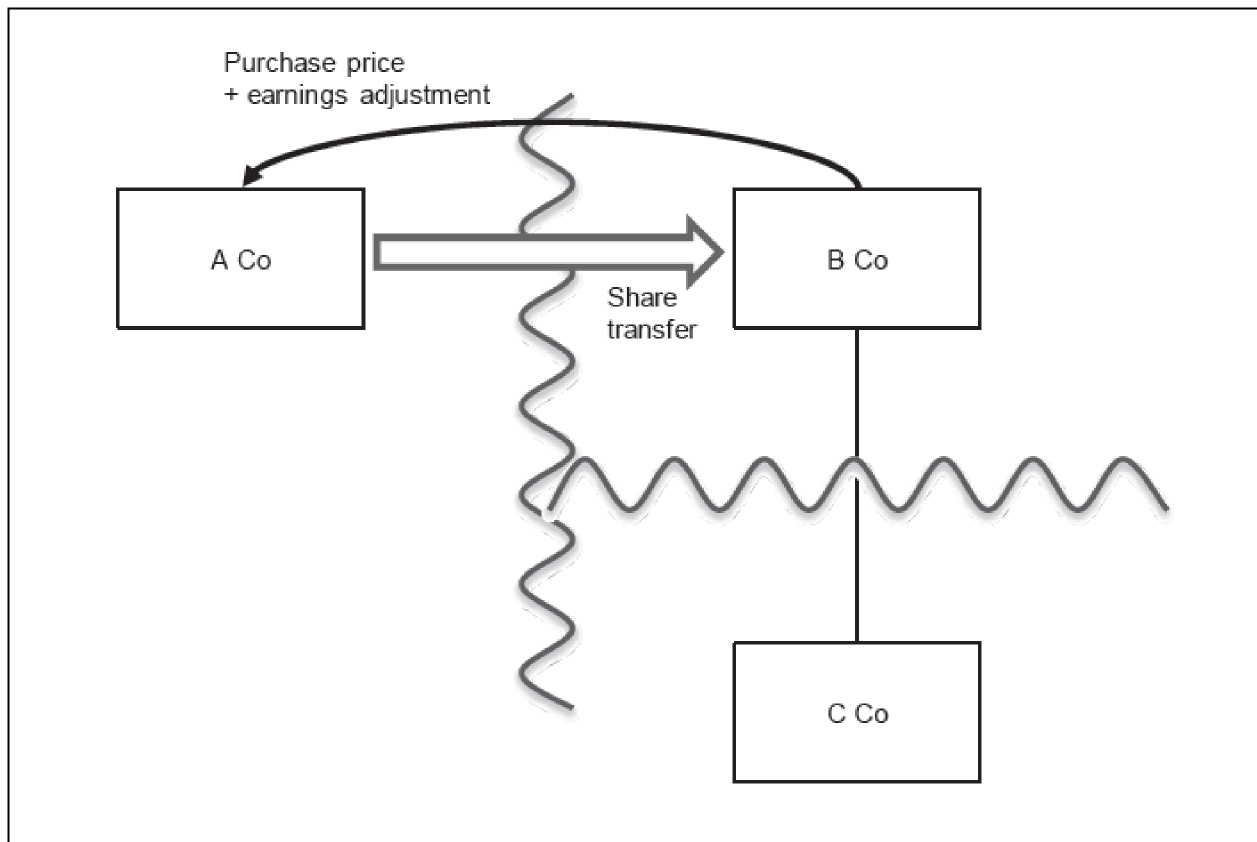
The first example regards the purchase price adjustment for retained earnings. [227]

In the example illustrated in the figure below, A Co (a company resident in Country A) transfers shares in C Co, a wholly-owned subsidiary resident in Country C, to B Co, a company resident in Country B, under a share sale agreement. B Co pays fair market value for the shares. While the share transfer occurs on the same day as the payment, the sale takes place partway through C Co's accounting period.

A Co is entitled to an adjustment to the purchase price. The amount of the adjustment will be calculated by reference to the operating income of C Co at the end of the accounting period.

[227] OECD/G20 Base Erosion and Profit Shifting Project, Action 2, 2015 Report, Ex 1.30;

This adjustment is treated as a deductible expense under Country B law while A Co treats the payment as consideration from the disposal of a capital asset and subject to tax at preferential rates.



Now the question that arise from these examples is: does the adjustment (substitute) payment fall within the scope of the hybrid financial instrument rule?

The hybrid financial instrument rule should be applied in Country B to deny a deduction for the payment if the payment is made under a structured arrangement. While the hybrid financial instrument rule will not generally apply in Country A (because A Co does not treat the payment as made under a financial instrument), the payment constitutes the payment of an equity return on the transferred shares that could be subject to adjustment under the substitute payment rules.

An analysis should now be given to explain better the choices coming from this example.

In particular, whether the asset transfer agreement should be treated as a financial instrument should be determined under local law.

The share sale contract could fall within the definition of financial instrument for the purposes of the hybrid financial instrument rule because it provides A Co with an equity based return. The report encourages countries to take reasonable endeavors to ensure that the hybrid mismatch rules apply to instruments that produce a financing or equity return in order to

ensure consistency in the application of the rules. The intention of the rules, however, is not to achieve harmonization in the way financial instruments are treated for tax purposes and, in hard cases, it should be left to local laws to determine the dividing line between financing instrument and other types of arrangement provided this is consistent with the overall intent of the rules.

From what has just been said, it is time to mention the application of the hybrid financial instrument rule on Country B and the application of the substitute payment rule in Country A.

Country B law does not treat the adjustment to the purchase price as subsumed within the consideration for the share sale but rather treats it as a separate deductible expense. The adjustment payment is in respect of an equity return under a financial instrument and should therefore be treated as a payment under a financial instrument under Country B law.

The adjustment payment gives rise to a D/NI outcome because the payment has no independent significance under Country A law and is simply treated as a component of the purchase price. The payment should be treated as giving rise to a D/NI outcome regardless of whether A Co is required to treat consideration from a share sale as ordinary income. This mismatch in tax outcomes is attributable to the differences in the tax treatment of the share sale agreement under Country A and Country B laws and is therefore a hybrid mismatch subject to adjustment under the hybrid financial instrument rule in Country B.

Where, as in this case, one country treats the arrangement as a financial instrument and the other does not, the adjustment made by the country applying the rule should be limited to the portion of the payment that is treated as giving rise to the equity return.

Regarding the application of the substitute payment rule in Country A, A Co does not treat the payment as made under a financial instrument (because the entire amount payable is treated under Country A law as consideration for the sale of shares).

If the hybrid financial instrument rule does not apply in Country B to neutralize the mismatch in tax outcomes the payment may still, however, be caught by the substitute payments rule in Recommendation 1.2(e). [228] Under this rule, a taxpayer that sells a financial instrument for a consideration that includes an amount representing an equity return on the underlying instrument (a substitute payment), is required to include such payment in income if the

[228] OECD/G20 Base Erosion and Profit Shifting Project, Action 2, 2015 Report, Recommendation 1.2(e): A substitute payment is any payment, made under an arrangement to transfer a financial instrument, to the extent it includes, or is payment of an amount representing, a financing or equity return on the underlying financial instrument where the payment or return would:

i. not have been included in ordinary income of the payer;
ii. have been included in ordinary income of the payee; or
iii. have given rise to hybrid mismatch;

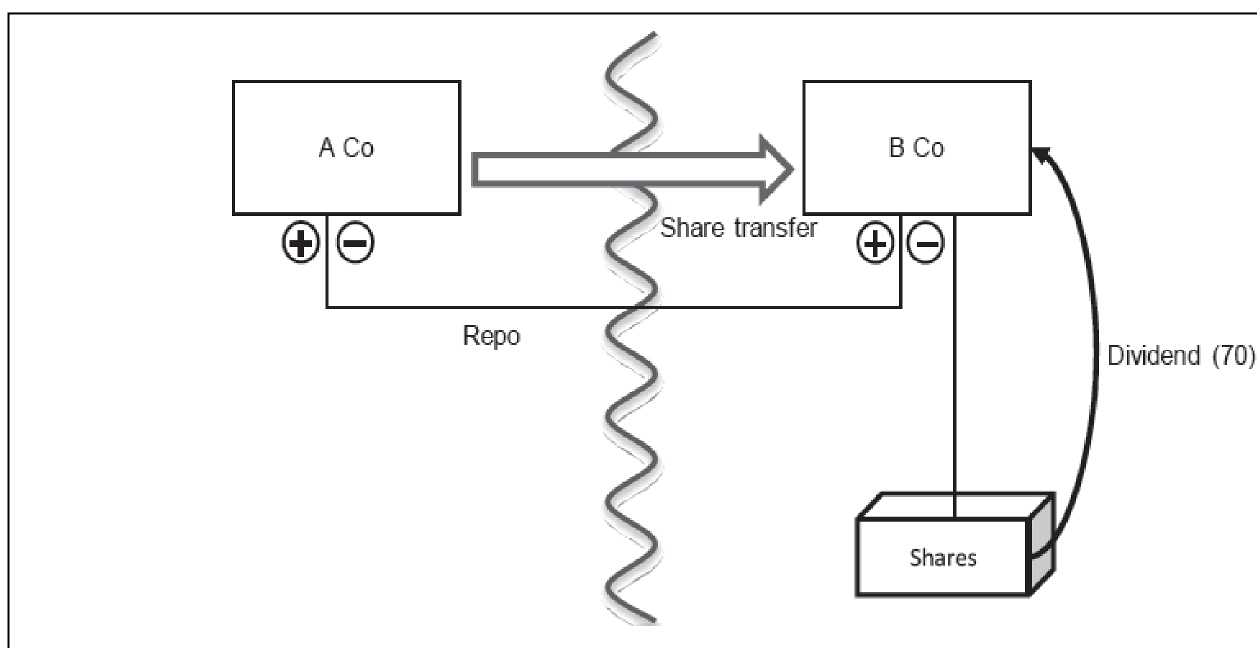
if it had been made directly under the financial instrument.

substitute payment is deductible under the laws of the counterparty jurisdiction and the underlying equity return would have been taxable if it had been paid directly under the financial instrument. Therefore, in this example, if A Co would have treated a dividend from C Co as ordinary income, the payment would be treated as a substitute payment and subject to adjustment under those rules.

Another way of treatment of substitute payments is highlighted in the example 1.35. We will explain hereafter the outcome of the example.

In the example illustrated in the figure below, A Co, a company resident in Country A, wishes to borrow money from B Co, an unrelated lender resident in Country B. B Co suggests structuring the loan as a sale and repurchase transaction (repo) in order to provide B Co with security for the loan and to secure a B Co with a lower tax cost (and therefore a lower financing cost for the parties) under the arrangement.

Under the repo, A Co transfers shares to B Co under an arrangement whereby A Co will acquire those shares at a future date for an agreed price that represents a financing return minus any distributions received on the B Co shares during the term of the repo. [229]



This type of financing arrangement can be described as a “net paying repo”. This is because B Co (lender under the arrangement and the temporary holder of the shares during the term of the repo) does not pay the dividends that it receives on the underlying shares across to A Co

[229] OECD/G20 Base Erosion and Profit Shifting Project, Action 2, 2015 Report, Ex 1.31;

(the economic owner of the shares). Rather those dividends are retained by B Co as part of its overall return under the financial arrangements.
In this example, both jurisdictions respect the legal form of the transaction (as a sale and repurchase of securities) so that neither jurisdiction treats the share loan as financial instruments for tax purposes.

A simplified illustration of the tax consequences of such an arrangements is set out below:

A Co			B Co		
	Tax	Book		Tax	Book
Income			Income		
Fee paid by B Co	5	5	Interest paid by A Co	25	25
Interest on collateral	25	25			
Gain on share loan	0	70			
Expenditure			Expenditure		
			Fee paid to A Co	(5)	(5)
Interest paid to B Co	(25)	(25)	Loss on share loan	(70)	(70)
Net return		**75**	**Net return**		**65**
Taxable income	**5**		**Taxable income**	**(50)**	

B Co is a share trader that, under Country B law, is required to include the net return from its trading activities in income. B Co borrows shares from A Co (a member of the same control group) in order to sell them "short".
B Co borrows the shares from A Co and sells them "short" (i.e. shares that borrower does not have) to an unrelated party for their market value of 1000. During the period of the share loan, B Co is required to pay a manufactured dividend [230] to A Co. B Co eventually buys back the shares for the same price and returns them to A Co to closeout the transaction. During the terms of the loan, A Co earns interest on the collateral. It pays both the collateral and the interest on that collateral back to B Co at the end of the transaction minus a fee.

[230] MANUFACTURED DIVIDEND: A payment that is received by a securities lender for a dividend distributed on a loaned security. By agreement, the borrower, in securities lending, remits to the lender any dividends, interest, or other distributions that are paid during the time that the securities are on loan. In essence, the lender is not entitled to receive any dividends from the ownership while a security is on loan. However, it is usual the lender and the borrower agree that the borrower must pay a manufactured dividend to the lender as a compensation for such a loss of income. Conventionally, securities lending arrangements provide that the borrower must pay to the lender a manufactured dividend in lieu of any dividends distributed on the loaned security. https://www.investment-and-finance.net/finance/m/manufactured-dividend.html

Rather than treating the manufactured dividend as a separate deductible item, both A Co and B Co treat is as an adjustment to the cost of acquiring shares. The total return from the share lending transaction for A Co and B Co can be calculated as follows:

	A Co	B Co
Market value of shares lent	1 000	(1 000)
Proceeds from the on market sale of borrowed shares		1 000
Additional amount paid to A Co in respect of manufactured dividend	70	(70)
Cost of re-acquiring shares on-market		(1 000)
Market value of shares returned	(1 000)	1 000
Total return on trade	70	(70)

B Co's loss on the share trade is deductible under Country B law while the gain on the share trade is treated as an excluded return under Country A law.

The question that arise from this example is: does the hybrid financial instrument rule apply to neutralize the mismatch in tax outcomes under these arrangements?

The answer is given directly from the OECD Action 2 report which says that the Recommendation 1.2 (e) (see footnote 81) will apply to neutralize the mismatch in tax outcomes if A Co would have been required to treat the dividend paid on the underlying shares as ordinary income or B Co would have been exempt on the underlying dividend.

It is worth analyze this example to understand deeply the meaning and the answer given by the OECD in the 2015 Final Report.

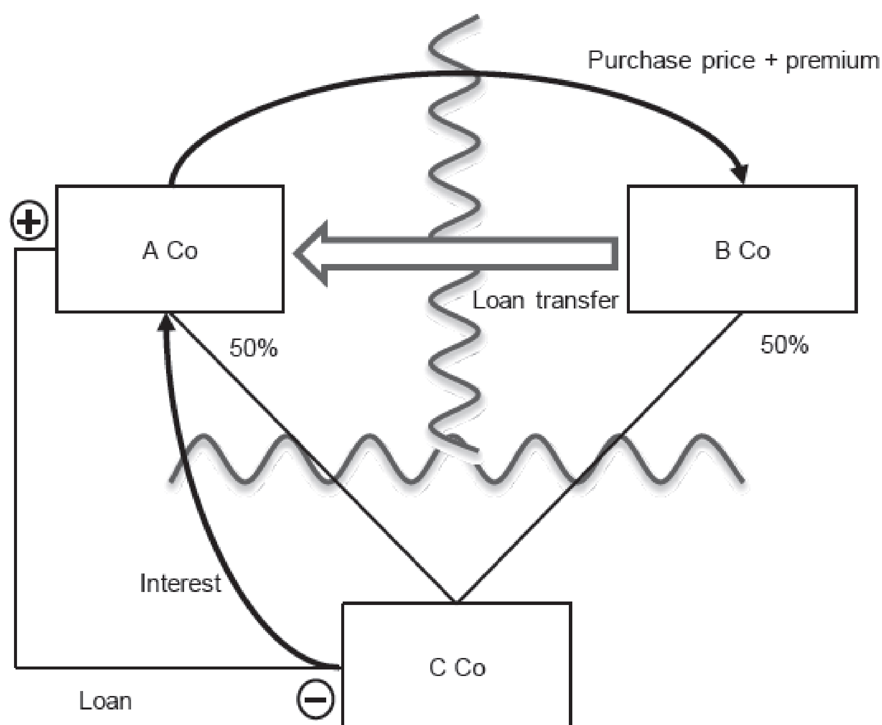
On one hand, manufactured payment is not treated as a payment under a financial instrument. Both A and B treat the share loan as a genuine sale so that the payment is not treated, under either Country A or Country B law, as a payment that is subject to the local law rules for taxing debt, equity or derivatives. Furthermore, the asset transfer is not treated as a hybrid transfer subject to adjustment under the hybrid financial instrument rule. Accordingly, neither Country A nor Country B will apply the hybrid financial instrument rule to adjust the tax treatment of the payment.

On the other hand, adjustment required to extent there is a mismatch in the tax treatment of the dividend and the manufactured dividend. An asset transfer arrangement such as this will give rise to tax policy concerns where the transfer results in the parties obtaining a better tax

outcome, in aggregate, than they would have obtained had the transferor received a direct payment of the underlying financing or equity return. If the asset transfer agreement effectively allows A Co to substitute what would otherwise have been a taxable dividend on the shares for non-taxable gain, or if B Co would have been entitled to an exemption on the underlying dividend than the Recommendation 1.2(e) will apply to adjust the D/NI outcome between the parties to prevent these type of arrangements undermining the integrity of the hybrid financial instrument rule.[231]

The last example worth to analyze to better understand the effectiveness of the substitute payments is the 1.36 of the OECD/G20 Base Erosion and Profit Shifting Project, 2015 Final Project. The example focuses on the deduction for premium paid to acquire bond with accrued interest.

In the example illustrated in the figure below, A Co (a company resident in Country A) and B Co (a company resident in Country B) each own 50% of the ordinary shares in C Co (a company resident in Country C). C Co issues a bond to B Co. The bond is treated as a debt instrument under the laws of Country C, but as an equity instrument (i.e. a share) under the laws of Country B. interest payments on the loan are deductible in Country C but treated as exempt dividends under Country B law. B Co subsequently transfers the bond to A Co.



[231] EXAMPLE 1.35, OECD/G20, Base Erosion and Profit Shifting Project, 2015 Final Report

The bond is issued for its principal amount of 20 million and has an interest rate of 12%, which is paid in two equal instalments throughout the year. A Co acquires the bond from B Co partway through an interest period under an ordinary contract of sale. A Co pays a premium of 0.8 million to acquire the bond which represent the accrued but unpaid interest on the bond. Under Country A law the bond premium can be deducted against interest income whereas, under Country B law, the premium is treated as an excluded capital gain. Below a table shows the tax treatment of A Co, B Co and C Co regarding the sale and purchase of the bond.

	A Co		B Co		C Co	
	Interest coupon	1.2	Interest coupon	-	Interest coupon	(1.2)
	Bond premium	(0.8)	Bond premium	-		
Net taxable income		**0.4**		**0**		**(1.2)**

As the table shows, the interest payment of 1.2 million gives rise to a deduction for C Co and income for A Co. A Co, however, is entitled to a deduction of 0.8 million for the premium paid on the bond. B Co does not receive any interest on the bond and treats the premium paid for the bond by A Co as an (exempt) gain on the disposal of an asset. In aggregate the arrangement gives rise to a deduction (for C Co) of 1.2 million and net income (for A Co) of 0.4 million.

As a consequence of this example, does the hybrid financial instrument rule operate to neutralize the mismatch in tax outcomes under these arrangements? Again, the Recommendation 1.2(e) comes to help us, so the premium paid for the bond is a substitute payment.
The following analysis of this example will shed light on the concept of substitute payments.
Firstly, we can say that the bond is a financial instrument but a payment of interest under the bond does not give rise to a mismatch in tax outcomes. While the payment of interest on the bond gives rise to a deduction within the scope of the hybrid financial instrument rule, the full amount of that payment is included in ordinary income under Country A law. Therefore, the payment of interest under the bond does not give rise to a mismatch in tax outcomes.
While the purchase price premium is deductible under Country A law and not included in ordinary income under Country B law, this payment is not a payment under the bond, but

rather a payment to acquire the bond and such a payment will only give rise a mismatch in tax outcomes under the hybrid financial instrument rule if the contract to acquire bond is treated as a financial instrument or a hybrid transfer.

Secondly, but most important outcome, from the example it emerges that the premium paid is a substitute payment.

Although neither party to the arrangement treats the sale contract as a financial instrument, the consideration for the sale of the bond includes an **amount representing a financing or equity return** on the underlying financial instrument that falls within the Recommendation 1.2(e). In this case, **the premium represents the accrued financing return on the underlying instrument**. **If that financing return had been paid directly to the transferor, it would have given rise to a hybrid mismatch** under Recommendation 1.

Accordingly, the payment of the premium should be treated as giving rise to a mismatch that is subject to adjustment under the hybrid financial instrument rule. [232]

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[232] EXAMPLE 1.36, OECD/G20, Base Erosion and Profit Shifting Project, 2015 Final Report

8 - Conclusions

In the light of what has been discussed in this work, we can conclude that a first new, great and important step has been taken towards the right direction, at least in theory, in studying and developing the issues related to hybrid mismatches.

At the beginning, the first organization that started thinking of analyzing, understanding and then explaining hybrid mismatches was the Organization for Economic Co-operation and Development with the creation of the BEPS project.

The first draft published in 2014 of the OECD, "Neutralize the Effects of Hybrid Mismatches" Action 2 report, had the aim of presenting and describing the concept of hybrid mismatch. It took 3-4 year, for the OECD, to deliver a more complete report both in term of content and analyses of the possible effects and consequences of the issue. It is quite clear why these reports are so complex and meaningful. It is not simple to study and explain a new problem with proper and understandable words to country recipients; it is time consuming and expensive in term of resources. This also means that, at every report published by the OECD on the matter of hybrid mismatches, new information and solutions will be found and communicated to jurisdictions in different countries through documentations and justifications to re-elaborate their home tax directive.

As far as the European Union is concern, the recent European Council Directive 2017/952 was created just to analyze and examine hybrid mismatches. Effort has been channeled into a single topic because it is considered nowadays of a huge importance. More and more multinationals companies are exploiting such instruments that allow them to avoid taxation and therefore increase profits. What happen if, in the next future. Countries will not be competent in tackling these problems? What will happen if different countries in the European Union have different methods of treating financial instruments?

Therefore, European Council Directive is trying to understand and treat these phenomena. Thanks to the great work of the pool of person who spend their time to work for the creation of the European Council Directive different new features of the hybrid mismatches were discovered. New instruments, new actors and new rules have been uncovered. This is a

critical work for the future. This last Council Directive is just the tip of the iceberg. In these days, several new drafts of a new council directive are going to be written with additions that will help us understand more clearly some elements only mentioned in the previous European Council Directive.

Despite this great effort of the legislators in drawing up the directive and the scholars in studying these phenomena there are still several dark sides.

One example of an issue not properly analyzed (the Directive only cited once) in the last European Council Directive 2017/952 and above all in the Italian Legislative Decree 29th November 2018 n.142, is the substitute payment.

Substitute payment, unlike the European Council Directive and the Legislative Decree, is a concept well discussed and analyzed in the OECD Action 2 report; there are also examples reported in order to better understand the instrument. Despite the information provided in the supra mentioned Action 2 report, substitute payment instruments are not present in the European Directive. After discovering the power and the effectiveness of these instruments, well explained by the OCED report, I was wondering why the European Council and the Italian jurisdiction did not introduce in the Directive the substitute payment instrument.

In the last part of the thesis, I tried to understand the reasons behind this decision from the European Union.

Since I cannot identify myself with the legislator, I tried to give a personal point of view and possible justifications for the lack of the substitute payments.

I started with an overview of the hybrid financial instruments in the Italian jurisdiction and compared them to the OECD report and the jurisdiction in which such instruments are already adopted. The focus on the substitute payment instruments comes in chapter 6 in which I describe the use of substitute payments both in the EU and Italian jurisdiction compared them to substitute payments in cross-border transactions outside the European Union.

Some interesting foods for thought emerged from the discussion. It can be too complicated to implement in the European soil; the European Union is not ready to treat this kind of specific instruments; the study made by the European Union on this instruments were to insufficient to allow the legislator to implement this kind of hybrid instruments.

From my humble perspective, I find interesting the thesis according to which the European Union and the Italian jurisdiction are not quite ready to understand and implement these instruments. Worldwide taxation rules are quite different from each other; this means that, to implement a complete new rule and a new instrument in the European Union, there must be a

whole study behind the innovative instruments. Differences of treatment between European Union and Extra European Union it is certainly a concrete reason why the EU Directive did not take into consideration the substitute payment as indicator to detect and stem hybrid mismatches.

A serious problem could emerge. If this issue regarding substitute payments remains unsolved and not included in the European Directive, a warning must be set.

If the European Union and the Italian jurisdiction are left behind and are not keeping up with the changes in the OECD and in other countries that have already applied the study of these hybrid instruments, we could be exploited for illegal purposes such as aggressive tax avoidance, tax reduction, profit shifting and so on. The countries that have already implemented this tool have obviously created limitations and barriers to block it, and therefore they would find an escape route in Italy and the European Union countries to bypass the problem.

As a consequences, the treatment of hybrid mismatches should not be considered in the same way across different jurisdictions. On the basis of the principle of proportionality (mandatory in the European regulation), a study must be drawn up which seeks to ensure that the hybrids mismatches, and not only those, are treated equally between jurisdictions. For example, the way in which hybrids are studied and treated in Italy should be proportional to that of other jurisdictions. In this way there is no longer any legislative discrepancy between different countries.

For this reason some instruments, described in the OECD recommendations, have not been considered and studied in the Italian Legislative decree and in the European directive, while others have been instead too much emphasized. According to the current directive, there is not yet a common thread that links the treatment of hybrids in the European Union.

This is to say that, at the moment, the issue of hybrid mismatches has yet to be fully understood and studied in all its facets. Anyhow, as far as this problem is concern, I believe that solutions will be taken by the European Union and a new Council Directive will be published which will amend and integrate the substitute payments.

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