Specific provisions on hybrid mismatches in the post BEPS Hungary

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1. Introduction

Since the financial crisis of 2008 we could encounter more often with news articles about the aggressive tax planning of multinational enterprises. Exploiting the loopholes in the international tax law makes them possible to shift their generated profit to low-tax jurisdictions. Besides the public, this practice of MNEs called the attention of the governments as well. Minimizing their tax burden had a substantial impact on the budget of the nations. In consequence, G20 countries entrusted the OECD in 2013 to develop an action plan within the framework of the BEPS project to tackle tax evasion and make sure that the income is taxed where it had been generated.

Hybrid mismatches were identified as one of the most important sources of Base Erosion and Profit Shifting (BEPS). Hybrid mismatches exploit the differences in the tax treatment of entities and financial instruments between two or more jurisdictions in order to achieve lower effective taxation on group level. The final report of Action 2 of the BEPS Action plan deals exclusively with hybrid mismatches and incorporates recommendations both on domestic rules and treaty issues to neutralize the effects of such arrangements. Throughout my paper I analyze the current hybrid provisions in the Hungarian tax system and examine the potential effect of the recommended provisions by the OECD on domestic and treaty level.

I have chosen this topic for two main reasons. Firstly, the OECD BEPS project has a historical significance in international taxation. We have not seen such a substantial international cooperation against tax avoidance and aggressive tax planning so far. The topic is very actual since the OECD has released the final reports of the BEPS Action plan in October 2015. In many countries, the recommended provisions may be implemented from 2016. Consequently, tax professionals dealing with international taxation are actively following the developments of the BEPS project in the whole world. We also have to be aware of the potential effects of these recommendations on the Hungarian tax system. Due to the fact that BEPS project covers a broad range of taxation topics, I endeavored to elaborate on one of the most significant tax challenges of nowadays: the issue of hybrid mismatches. The second main reason of choosing this topic is that there is no currently available Hungarian literature about the BEPS discussion and its potential effects. I hope my paper will constitute a useful tool to comprehend the potential changes in the Hungarian specific provisions on hybrid mismatches.

In the first part of the paper I introduce the Hungarian corporate taxation from hybrid mismatch perspective based on the Act LXXXI of 1996 on Corporate Tax and Dividend Tax and other relevant provisions from other acts. In the beginning of this part I elaborate on the features of the Hungarian tax system, such as the treatment of foreign entities or the taxation of partnerships and corporations. After having the basics discussed, I introduce the two most important Hungarian anti-hybrid rule: the definition of the dividend (against hybrid financial instruments) and a general anti-avoidance rule aimed at hybrid entities. At the end of the first part I illustrate the aforementioned provisions in practice through four different exemplary case studies.

The second part of the paper starts with the introduction of the Action plan’s recommendations regarding the OECD Model Tax Convention. I elaborate mainly on the proposed Article 1 (2) provision and the recommended modification concerning Article 4 (3). I have conducted a research on the recently signed Hungarian tax conventions in order to size up the impact of the BEPS discussion on the Hungarian treaty-legislation. Besides the
recommendations concerning hybrid mismatches I have also examined other action’s potential effect on the Hungarian tax treaties. After the examination of recent conventions I introduce the Hungarian practice in treaty interpretation and application through several case studies. In the end of this part I deal with the advantages and disadvantages of implementing the outlined recommendations through a multilateral instrument.

As Hungary has been member of the European Union for twelve years, it is important to scrutinize the EU-law aspects of the hybrid provisions as well. In the beginning of the last part of my paper I analyze the current Hungarian practice regarding hybrid entities and hybrid financial instruments from EU-law perspective. It was also important to examine the potential effect of the implementation of the proposed provisions. Finally, I conducted an investigation on the impact of the BEPS discussion on directives and EU law concerning direct taxation.

I would like to take this opportunity to thank dr. Gergely Czoboly and Gabriella Erdős for their support and useful advices throughout my research.
2. Hybrid mismatches on the domestic level

2.1 Reasons for the existence of hybrid entities

2.1.1 Legal entities in Hungary

Hungarian Civil Code declares the possible legal forms of carrying out business activity in Hungary (business organizations). One of the most common legal forms is the Limited liability company (Kft). Kft has a capital requirement of 3 million HUF that can be contributed by cash or any kind. It can be established by one or more owners and the corporate members have limited liability. Company limited by shares (Rt) use to be chosen by larger enterprises. However, there are two types of this legal form: Private limited company (Zrt) and Public limited company (Nyrt). The capital requirement for establishing a Zrt is 5 million HUF and the proportion of cash contribution in the share capital may not be less than 30%. Nonetheless, shares of Zrt cannot be listed publicly, they have to be secured entirely by subscription. The capital requirement of Nyrt is 20 million HUF and its shares may be listed on any stock exchange. However, Rt can be established only in Zrt form at the outset. After launching its operations it may be registered as a Nyrt.

There are two more legal forms to incorporate business activities: general partnership (Kkt) and limited partnership (Bt). Kkt does not require any initial capital contribution and its members have joint and unlimited liability. In case of Bt there are two types of partners: general partner and limited partner. It is compulsory to have at least one general partner who is severally liable. In contrast, the limited partner has limited liability.

The following chart summarizes the Hungarian legal entities and their criteria:

<table>
<thead>
<tr>
<th></th>
<th>General Partnership (Kkt)</th>
<th>Limited Partnership (Bt)</th>
<th>Limited Liability Company (Kft)</th>
<th>Company Limited by Shares (Rt)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal status</td>
<td>Non-legal person</td>
<td>Non-legal person</td>
<td>Legal person</td>
<td>Legal person</td>
</tr>
<tr>
<td>Liability</td>
<td>Unlimited liability</td>
<td>Unlimited (General partner) and limited (Limited partner) liability</td>
<td>Limited liability</td>
<td>Limited liability</td>
</tr>
<tr>
<td>Capital requirement</td>
<td>-</td>
<td>-</td>
<td>3 000 000 HUF</td>
<td>5 000 000 HUF</td>
</tr>
</tbody>
</table>

1. Table: Hungarian legal entities
According to the Act on the investments of foreigners in Hungary\(^1\), foreigners have two possibilities to carry out business activity in Hungary: register a branch or establish a company of any of the listed legal forms.

At this point we have to mention the **Civil law partnership (Pjt)**\(^2\) as well. Since the 2013 amendment of Civil Code, it is possible to set up a Pjt solely for business purpose. The Civil Code enables parties to sign a civil law partnership agreement in order to achieve their common goals. Civil law partnership is not a legal entity, therefore it is not subject to corporate income tax. Instead, the obtained income by the civil law partnership is taxable on the level of its members in proportion to their share.

### 2.1.2 Key principles of company taxation in Hungary

The first paragraph of the Act on Corporate Tax and Dividend Tax (hereinafter: Act on Corporate Tax) describes the main principles that should be followed when applying the provisions of this act.

The first principle is our **General Anti-Avoidance Rule (GAAR)** which states that a tax reduction, exemption, or any other benefit is available only if the transaction is in line with the purpose of the rule. Despite the endeavor of the Hungarian government to make the tax system more efficient in tackling aggressive tax planning, there are still loopholes that can be exploited by companies to lower their tax burden. Therefore, this rule plays an important role in preventing tax-evasion that cannot be avoided by Specific anti-avoidance rules (SAAR’s).

The second general principle prescribes that if the Act on Corporate Tax enables deductions, reductions, tax exemption or tax benefit multiple times under different titles, on the same factual basis, then it can be applied only once.

The next principle ensures that in case of a mismatch between domestic law and international contract, the provisions of the international contract have priority over domestic rules.

And finally, the last main principles declare that the Act on Corporate Tax must be interpreted in line with the Accounting Act, unless the company in question keeps its books according to the IFRS.

The Hungarian Act on Corporate Tax does not make difference between the taxation of corporations and partnerships. Each entity doing business in Hungary is taxable on the level of the entity. Thus, classical fiscally transparent entities do not exist in the Hungarian law (General partnerships, Limited partnerships and trusts registered in Hungary are regular taxable entities).

In terms of tax liability, domestic tax law separates **resident** and **nonresident taxpayers**. Resident taxpayers are liable to tax after their income derived both from Hungary and abroad (total tax liability), however nonresident taxpayers are liable to tax only after their income derived from Hungary (limited tax liability).

According to the Hungarian law, the following entities are deemed as **resident taxpayers** (only those entities are listed that are the most relevant regarding my research on hybrid structures):

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\(^1\) Act XXIV of 1988 on the investments of foreigners in Hungary

\(^2\) Act V of 2013 on the Civil Code, Section 6:498
Business associations (General partnership, Limited partnership, Limited liability company, Private limited company, Public limited company),

- Cooperative societies,
- Public companies, trusts and other state-controlled economic organizations,
- Foundations, NGO's,
- Sole proprietorships,
- Any foreign person, whose principal place of management is located in Hungary.

In addition, a new paragraph enacted in 2014 expands the range of resident entities: “A trust fund managed under a fiduciary asset management contract shall be treated as resident taxpayer.”  

According to the Act on Corporate Tax, the following foreign persons shall be treated as nonresident taxpayers:
- those, who carry out business operations at their branches (PE) in Hungary, provided that they are not considered resident taxpayers due to the location of their principal place of management,
- those, who obtain any income through the transfer or withdrawal of participating interest in a company with real estate holdings.

As we can see, the Hungarian Act on Corporate Tax does not provide any principles of transparent and opaque taxation. All business associations are considered as resident taxpayers and they are taxed on the level of the entity. However, the aforementioned Civil law partnership (Pjt) does not belong to business associations and it is not listed among resident taxpayers neither. Hence, the obtained income of Pjt shall be taxed on the level of its members under the Act on Personal Income Tax or Act on Corporate Tax depending on the legal classification of its members.

2.1.3 Provided options for companies

As the Hungarian corporate taxation does not distinguish systematically between corporations and partnerships and does not provide principles for transparent and opaque taxation, entities do not have the opportunity to choose between different tax treatment (being transparent or nontransparent). In Hungary each company is taxed on the level of the entity.

Once we are at options that companies can choose from, we have to discuss the consolidation rules (or group relief rules). There are some countries where groups consisting of many companies can opt for group taxation or consolidated taxation. This option offered to companies has significant importance on our examination of hybrid structures. We will see that some tax structures utilizing hybrid entities build on consolidation rules. Although, Hungary does not provide such an option to companies (only for VAT purposes), each entity has to submit its tax return independently and their corporate tax is determined accordingly.

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3 Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 2 (6)
2.1.4 Treatment of foreign companies

Foreign companies have two possibilities to carry out business activity in Hungary: either through a Hungarian subsidiary or through a branch. Having a branch established means that under the Act on Corporate Tax, the foreign entity becomes a nonresident taxpayer. Therefore, regardless its legal classification (transparent or nontransparent) in the country of its residence, it will be taxable on the income derived by its branch (PE) on the level of the entity.

A more interesting situation is when a foreign company derives dividend, interest or royalty income from Hungary that is not attributable to a PE. For such a case, there is no rule in the domestic tax system for matching the legal form of the foreign company in question with legal form known by the Hungarian Civil Code. The reason of this is that the Hungarian Act on Corporate Tax does not distinguish between the taxation of corporations and partnerships. Regardless of foreign company’s legal form, tax liability is determined on the level of the entity. However, Hungary does not levy withholding tax on dividend, interest and royalty payments to foreign companies. Due to this fact, qualification of the foreign entity is not relevant from tax perspective.

2.1.5 Hybrid entities

From my perspective, the following definition describes term “hybrid entity” the most appropriate:

A hybrid entity is an entity that is fiscally transparent for one jurisdiction’s tax purposes, but not fiscally transparent for an other jurisdiction’s tax purposes; and which contributes to a tax saving structure.

The point regarding hybrid entities that there is a mismatch between the treatment of an entity among different countries. However, being part of a tax saving structure is also a significant feature of this kind of entities.

When we investigate hybrid entities in terms of home and foreign countries, we can separate “hybrid entities” from “reverse hybrid entities”. In this sense, hybrid entity is an entity that is fiscally transparent for home country’s tax purposes, but not fiscally transparent for foreign tax purposes. Similarly, a reverse hybrid entity is an entity that is fiscally transparent for foreign tax purposes, but not fiscally transparent for home country’s tax purposes.

Partnerships are typical fiscally transparent entities, while corporations are typical fiscally nontransparent entities. Limited liability companies and other types of companies may be both fiscally transparent and nontransparent.

2.2 Hybrid financial instruments

Besides hybrid entities, hybrid financial instruments are also popular tools among multinational enterprises for optimizing their tax burden. In my opinion, definition that derives from OECD’s deliverable of Action 2 of the BEPS Project describes the term “hybrid financial instrument” most precisely:

“The hybrid financial instrument is a financial instrument that is subject to a different tax treatment under the law of two or more jurisdictions such that a payment under that instrument gives rise to a mismatch in tax outcomes.”
The most common financial instrument that used to be utilized for illustrating hybrid financial instruments is permanent interest bearing share (PIBS). The treatment of the payment made under this financial instrument is often different in the payer jurisdiction and the payee jurisdiction. In case of mismatch, the payer jurisdiction treats the payment as an interest payment, therefore enables the payer entity to deduct the amount of the payment; the payee jurisdiction however, handles the payment as a dividend and disregards it in order to avoid economic double taxation. The mismatch that we have seen between tax jurisdictions leads us to a Deduction/No Inclusion (D/NI) outcome.

Hungarian tax law does not specify the exact term of “hybrid financial instrument" concretely, but refers to the payment made under hybrid financial instrument in the definition of dividend.\(^4\) Therefore, it may be considered as a bottom-up approach, but we are going to discuss this provision later below.

### 2.2.1 Equity and liabilities

The Hungarian Act on Corporate Tax does not specify “debt" and “equity" terms within the Definition section as general terms applicable for the whole Act, although it provides definitions for “liability" and “equity capital" terms for the purpose of thin capitalization rule. I will endeavor to provide the full definition below:

a) ‘\textit{liability}’ shall mean the average daily balance of outstanding loans, outstanding debt securities offered privately and bills payable (with the exception of bills payable on account of suppliers’ debts), and any other liability other than loans, debt securities and bills payable shown in the balance sheet that entails the payment of interest from, or charged to, the taxpayer’s profit, or on account of which the taxpayer’s pre-tax profit is reduced according to Section 18 (with the exception of debts of credit institutions and financial companies incurred in connection with and for the purposes of financial service activities, and with the exception of accounts payable for goods and services received), from which the daily average of monetary claims (excluding accounts receivable for goods and services supplied) shown in the balance sheet under financial investments, receivables or securities for the tax year may be deducted;

b) ‘\textit{equity capital}’ shall mean the average daily balance of subscribed capital, capital reserve, retained earnings and tied-up reserves (or own funds of the like).\(^5\)

Note, that the previous definition excludes the debts of credit institutions and financial companies from the liabilities. The reason behind this will be introduced below, at the thin capitalization rule section.

Furthermore, the Act C of 2000 on Accounting provides with a more general definition of the two terms:

“A \textit{company’s equity} shall consist of subscribed capital (decreased by the amount which has not yet been paid up), capital reserve, retained earnings, tied-up reserves, valuation reserve, and the balance sheet total for the current year."\(^6\)

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\(^4\) Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 4 28/b

\(^5\) Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 8 (5) a) b)
“Liabilities are the acknowledged debts expressed in money and arising from supply, work, service and other contracts which are related to supplies, services and the provision of money already performed by the supplier, company, service provider, creditor or lender, and accepted and acknowledged by the company, including the management operations concerning state property or local government property entrusted to an asset management company on the strength of statutory provision or legal authorization. There are subordinated, long-term and short-term liabilities.”

2.2.2 Treatment of interest expenses and dividend payments

In international tax planning, the treatment of passive income, such as dividend, interest and royalty has particular significance. As we will see, Hungary grants favorable tax treatment of passive income, thus making the country an attractive location for setting up a holding company.

From the receiving company perspective, domestic tax system disregards the received dividend, it is not part of the company’s regular income. However, dividend received from a controlled foreign company (CFC) forms part of the taxable income. Also, those dividend payments that have been deducted from the payer company’s pre-tax profit are not exempted from taxation at the recipient.

The Act on Corporate Tax does not provide such benefit for the received interest, which is part of the receiving party’s regular income. On the other hand, received royalties are treated favorably. According to a preferential provision, 50% of the received royalty may be deducted from the receiving company’s tax base regardless of being the developer of the concerned IP or not. However, the amount deducted from the pre-tax profit under these provisions shall not exceed 50 per cent of the pre-tax profit.

In terms of the paying company, Hungary does not levy withholding tax on dividend, interest and royalty payments. Paid dividends are not deductible apparently, as being paid from after-tax profit. Although, the deduction of interest and royalty payments from the pre-tax profit is allowed by Hungarian rules as being cost items of the paying company. At this point we have to note that interest payments to related parties are limited by the thin capitalization rule (I will elaborate on this provision later).

The following chart summarizes the treatment of passive income in Hungary:

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6 Act C of 2000 on Accounting, Section 35 (2)
7 Act C of 2000 on Accounting, Section 42 (1)
8 Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 7 (1) g)
9 The undistributed after-tax profit of the CFC can also be subject to tax (Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 8 (1) f))
10 Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 7 (1) s)
11 Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 7 (14)
<table>
<thead>
<tr>
<th>Paying/Receiving company</th>
<th>Type of payment</th>
<th>General treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receiving company</td>
<td>Interest</td>
<td>Part of the regular income</td>
</tr>
<tr>
<td></td>
<td>Dividend</td>
<td>Not part of the tax base (except of when it is received from a CFC or if it was deducted at the payer’s side)</td>
</tr>
<tr>
<td></td>
<td>Royalty</td>
<td>50% of the received royalty may be deducted (up to 50% of the pre-tax profit)</td>
</tr>
<tr>
<td>Paying company</td>
<td>Interest</td>
<td>Deductible (but limited by thin capitalization rule!) No withholding tax</td>
</tr>
<tr>
<td></td>
<td>Dividend</td>
<td>Not deductible No withholding tax</td>
</tr>
<tr>
<td></td>
<td>Royalty</td>
<td>Deductible No withholding tax</td>
</tr>
</tbody>
</table>

2. Table: The treatment of dividend, interest and royalty in Hungary

2.3 Domestic Anti-Avoidance measures

2.3.1 General Anti-Avoidance Rule (GAAR)

As we have already mentioned before, a General Anti-Avoidance Rule (GAAR) is declared among basic principles of the Act on Corporate Tax. Since it is a compact and concise rule, I will endeavor to provide the full definition below:

“Any rule, tax incentive (tax relief, tax allowance) which affects tax liability or the amount of taxes, or that results in the reduction of taxes may be used and/or claimed to the extent that the essence of the transaction to which it pertains or other similar action manifests the purpose of the rule or tax allowance. The burden of proof as to applicability or enforceability lies with the party in whose interest it stands. If the nature or substance of the transaction suggests that the sole purpose of the transaction is to obtain a tax advantage in favor of any or all parties concerned, the costs and expenditures charged on the basis of such transaction shall not be treated as ordinary business expenses, i.e. that have been paid or incurred in the course of business, and no tax allowance may be claimed.”

Hungary was the first among the Middle-Eastern-European countries to adopt a GAAR. The Hungarian GAAR has been present among the key principles of the Act LXXXI

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12 Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 1 (2)
of 1996 on Corporate Tax and Dividend Tax since its gazette version (1996). The GAAR provides for the following:

- classification of a transaction in conformity with its real content;
- requirement of proper legal practice;
- reference to rules of connected transactions;
- limitation on transfer pricing among related parties.

The adoption of GAAR rules was motivated by growing tax avoidance which increased in tandem with the complexity of tax law. The legislature hoped to close loopholes that provided opportunities for tax avoidance. The rules can be viewed as a success as they have slowed entry into tax avoidance transactions. It is also an important weapon for the taxing authority. The constitutional basis for anti-avoidance legislation is the obligation of equality of sacrifice.

As the mentioned rule is not restricted to domestic transactions, it is binding for cross-border transactions as well. Both the legislature and the courts have employed a substance over form analysis in the following circumstances:

- when qualifying transactions according to their real content;
- when interpreting national law in harmony with EU law;
- when determining whether eligibility for tax relief is based on a fictitious contract.

Courts are given discretion to examine every step of a transaction, viewing the transaction as a whole in determining tax law consequences.

2.3.2 Specific Anti-Avoidance Rules (SAARs) concerning hybrid entities

At first sight, there are not any hybrid-specific anti-avoidance rules in the Hungarian domestic tax system. Term “hybrid entity” or any with similar meaning are not defined in the Hungarian regulation at all. However, a new general principle has been enacted to Act on the Rules of Taxation in 2015. This rule aims to address those situations, when none of the contracting states treat the income as taxable due to the available facts or the different interpretation of the tax convention. In such case, this provision entitles Hungary to refuse to grant the exemption of the mentioned income.

As we can see, this rule is pretty similar to General Anti-Abuse Rules and does not include any concrete in connection with hybrid entities. On the other hand, if we take a look at the official law justification, we can see the legislature’s intention with introducing this new rule: “The modification aims to clarify the application of the law regarding a typical aggressive tax planning structure (so-called hybrid structures)”

Despite the fact that a key principle in the Act on Corporate Tax declares the international contract/agreement’s priority over domestic rules, the anti-avoidance rule in question is a tax treaty override provision. Germany has also introduced similar unilateral switch-over and subject-to-tax rules in order to tackle tax-avoidance more effectively.

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15 Act XCII of 2003 on Rules of Taxation, Section 2 (2)
16 T/1705 bill to Act LXXIV of 2014, Section 174
The mentioned provision helps to avoid double non-taxation in case of mismatch between the tax treatment of different jurisdictions. Although, the rule may not be limited to the extent of hybrid entities, it shall also be applied to cases when the tax treatment of income or PE differs between states and results in double non-taxation. The concerned Hungarian provision may remind us to “switch-over” clause incorporated in some tax treaties as an instrument against double non-taxation. The switch-over clause enables the contracting state to switch from exemption method to credit method if:

1. in the contracting states items of income or capital are placed under differing provisions of the applied tax treaty or attributed to different persons, and
2. if this conflict cannot be settled by a mutual agreement procedure, and
3. if as a result of this difference in placement or attribution the relevant income or capital would remain untaxed or be taxed lower than without this conflict.\(^\text{17}\)

The previous points are the main features of the switch-over clause, although, these clauses may differ in tax treaties, since the OECD Model Convention does not include a unified pattern of such clause.

We may notice, that the Hungarian unilateral provision meets only the first feature of switch-over clause: it gears the application of the rule to different interpretation of the provisions of the applied treaty or the prevailing facts between countries. The Hungarian anti-avoidance rule in question does not require a mutual agreement procedure to be conducted before applying the provision. This feature can make the rule more robust and efficient, since mutual agreement procedures may last a long time. Another significant difference is that despite switch-over clause enables to switch from exemption method to credit method even if the concerned income is taxed lower than without a mismatch, Hungarian rule enables taxation of the income only in that case if the outcome of the mismatch is non-taxation. From this perspective, switch-over clause may be considered as a stricter anti-avoidance rule than the Hungarian provision.

<table>
<thead>
<tr>
<th>Tax outcome of treaty interpretation conflict</th>
<th>Mismatch without tax impact</th>
<th>Lower taxation due to mismatch</th>
<th>Non-taxation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Switch-over clause</td>
<td>Not applicable</td>
<td>Applicable</td>
<td>Applicable</td>
</tr>
<tr>
<td>Hungarian treaty override provision</td>
<td>Not applicable</td>
<td>Not applicable</td>
<td>Applicable</td>
</tr>
</tbody>
</table>

3. Table: Switch-over clause vs Hungarian provision

### 2.3.3 Dual resident entities

Each of the listed provisions are applicable to dual resident companies as well. An entity qualifies as a tax resident in Hungary if its place of effective management is situated in Hungary. Under domestic tax law, dual resident entities are treated the same way than those who are tax resident only in Hungary as there are no special rules for entities being resident in two jurisdictions. Moreover, term "dual resident" is not declared in the Act on Corporate

Tax neither. However, we have to remark, that Hungarian widespread network of tax treaties may help to cope with tax avoidance by dual resident structures. As being an OECD member state, most of Hungary’s tax treaties are based on the OECD Model Convention, which regulates the issue of double residence in Paragraph 3 of Article 4: Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

I will elaborate on this issue later below at the second part of my paper.

2.3.4 Specific Anti-Avoidance Rules (SAARs) concerning hybrid financial instruments

In general, the received dividend - unless it is received from a controlled foreign company - is a deductible item from the pre-tax profit in the Hungarian tax law with the aim of avoiding economic double taxation. However, in order to address tax-evasion derived from hybrid financial instruments, Hungarian legislature changed the definition of the dividend in the Act on Corporate Tax in 2012. Since then the new definition of the dividend is the following:

“dividend” shall mean the sum shown as dividends under income from financial transactions according to the Accounting Act, or any sum of the like in the case of taxpayers drawing up annual accounts, closing accounting statements in accordance with IFRSs, provided that this sum is not claimed by the company paying the dividend (including managed assets) as an expense from its pre-tax profit.  

Regardless the type of financial instrument, the payment that is deducted by the paying company, does not qualify as a dividend in Hungary according to the Act on Corporate Tax, therefore, it shall be included in the ordinary income of the payee. Hungary is the first country that introduced an anti-financial hybrid instrument rule in the V4 region.  

If we recall the BEPS Action 2 Final report, we can see a similar recommendation by the OECD (secondary or defensive rule against hybrid financial instruments):

1. Denial of dividend exemption for deductible payments

In order to prevent D/NI outcomes from arising under a financial instrument, a dividend exemption that is provided for relief against economic double taxation should not be granted under domestic law to the extent the dividend payment is deductible by the payer. Equally, jurisdictions should consider adopting similar restrictions for other types of dividend relief granted to relieve economic double taxation on underlying profits.

On the other hand, this rule can tackle only one side of the problem. According to the BEPS Action 2 Final report, the primary rule against hybrid financial instruments shall be the following:

18 Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 4 28/b
19 V4 countries: Czech Republic, Hungary, Poland, Slovakia
20 OECD (2015a) p. 45.
The payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/NI outcome. Unfortunately, there is not such rule present in the Hungarian domestic tax system so far.

2.3.5 Specific Anti-Avoidance Rules (SAARs) in general

As a reaction to the aggressive tax planning of MNEs, Hungary has introduced many Specific Anti-Avoidance Rules (SAAR’s) in order to protect its corporate tax base. Since the end of 20th century, Hungary has been the leader in the V4 region in terms of anti-avoidance rules. Provisions, like Controlled Foreign Company (CFC) rule and Thin capitalization rule has been present in Act LXXXI of 1996 on Corporate Tax and Dividend Tax since its gazette version (1996). I have conducted a research on the V4 countries in order to size up the level of development of their anti-avoidance rules. The following chart provides a summary of these regulations in the V4 countries:

<table>
<thead>
<tr>
<th>V4</th>
<th>Hungary</th>
<th>Poland</th>
<th>Czech Republic</th>
<th>Slovakia</th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAR</td>
<td>✓</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>CFC Rule</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Thin Capitalization Rule</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>TP documentation requirement</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>✓</td>
</tr>
<tr>
<td>Anti-Hybrid Rule</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

4. Table: Anti-avoidance rules in V4 countries

According to the Hungarian CFC rule, a foreign nonresident entity is considered as a controlled foreign company, if at least 10% of its shares are possessed directly or indirectly by a Hungarian resident or most of its income derives from a Hungarian source and the foreign entity’s effective tax rate is less than 10%. However, CFC rules does not apply to those foreign entities that are tax residents in one of the OECD or EU member countries or in such a country that have concluded a tax treaty with Hungary. The undistributed income of the controlled foreign company is taxable at the level of its Hungarian shareholder in proportion to its share. In turn, double taxation is prevented by not levying tax on those dividends that are paid from a CFC income that have already been taxed in the hands of the Hungarian resident shareholder. Also, those expenses that incurred against a CFC, may not be deducted in general, just in those cases when it is demonstrated that the cost in question incurred for business purpose. As the provision declares that the rule is binding for all foreign

21 OECD (2015a) p. 23.
persons, it concerns partnerships and other transparent entities as well. The Hungarian CFC rules entirely comply with the recommendations outlined by the Final report of BEPS Action 3.

**Thin capitalization rule** is the second oldest anti-avoidance rule in Hungary’s current Act on Corporate Tax. Thin capitalization rule aims to limit the deductibility of interest that is paid on intra-group debt. Interest on debt (with the exception of receivables due from financial institutions) exceeding three times the taxpayer’s equity capital is nondeductible for corporate income tax purposes in Hungary. Therefore, domestic thin capitalization rule helps to limit the potential negative impact of hybrid mismatch structures by setting an upper limit of interest deductions. However, as we can see, Hungarian legislation restricts the deductibility of interests based on the company’s leverage (Debt/Equity ratio). If we recall the recommendations expressed by BEPS Action 4 Final report regarding interest deductions, we can notice that the recommended “Fixed ratio rule” restricts the amount of deductible interest by a determined percentage of the company’s EBITDA. In order to determine the strictness of both methods, I compared the amount of allowed interest deductions by both rules on some Hungarian Public limited companies (Nyrt):

<table>
<thead>
<tr>
<th>Public limited companies (Nyrt)</th>
<th>∑ Equity (million HUF)</th>
<th>EBIT (million HUF)</th>
<th>EBIT ROE (%)</th>
<th>Allowed interest deduction by Fixed ratio rule (30% of EBIT) (X)</th>
<th>Allowed interest deduction by Thin capitalization rule (Y)</th>
<th>X/Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>MOL</td>
<td>2,195,738</td>
<td>40,080</td>
<td>1.8%</td>
<td>12,024</td>
<td>526,977</td>
<td>2.3%</td>
</tr>
<tr>
<td>Richter</td>
<td>561,730</td>
<td>37,747</td>
<td>6.7%</td>
<td>11,324</td>
<td>134,815</td>
<td>8.4%</td>
</tr>
<tr>
<td>ÉMÁSZ</td>
<td>70,822</td>
<td>6,938</td>
<td>9.8%</td>
<td>2,081</td>
<td>16,997</td>
<td>12.2%</td>
</tr>
<tr>
<td>Rába</td>
<td>15,074</td>
<td>1,891</td>
<td>12.5%</td>
<td>567</td>
<td>3,617</td>
<td>15.7%</td>
</tr>
<tr>
<td>Any</td>
<td>6,838</td>
<td>1,423</td>
<td>20.8%</td>
<td>427</td>
<td>1,641</td>
<td>26%</td>
</tr>
</tbody>
</table>

Arm’s length interest rate: 8%

As we can see from the chart, Fixed ratio rule - even with the most permissive setting (30% of EBITDA) - is much more restrictive towards interest deduction than the current Thin capitalization rule. In fact, the difference between the effect of the two rules highly depends on companies’ ROE. For instance, the difference between the allowed interest deductions is larger in case of MOL that has a poor ROE, than in case of Any with a higher ROE. In overall, we can identify that introducing an EBITDA-based Fixed ratio rule to the Hungarian

22 ‘foreign person’ shall mean a legal person, business association lacking the legal status of a legal person, a partnership and any other organization established under foreign law (Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 4, par. 27)

23 Source of data: Budapest Stock Exchange, 2014 financial data
tax system - based on the recommendations outlined by BEPS Action 4 - could limit the negative impact of hybrid mismatch structures more effectively.

Let’s take those tax structures that include a hybrid entity only with a debt bearing purpose in order to make deductions of the interest expenses in two jurisdictions. The previously outlined “Fixed ratio rule” does not allow any interest deductions for the hybrid entity in question unless it does not have any produced profit (Dual inclusion income) for offsetting the arisen interest expenses. On the other hand, current Hungarian Thin capitalization rule would allow the mentioned deduction of interest expenses.

Finally, once we are discussing Special Anti-Avoidance Rules, we have to mention Transfer Pricing rules as well. If the applied price at transactions between related parties is not in line with arm’s length principle, the transfer pricing rules\textsuperscript{24} require the tax base to be adjusted accordingly. Taxpayers with related party transaction has been obliged to maintain a Transfer pricing documentation since 2003. The arm’s length pricing of each related party transaction with more than 50 million HUF value has to be proven independently in the TP documentation. For the determination of arm’s length prices, Act on Corporate Tax specifies the following methods:

- Comparable uncontrolled price method
- Resale minus method
- Cost-plus method
- Transactional net margin method
- Profit split method

However, if none of these methods is eligible for determining the correct arm’s length price, then taxpayer may use other methods to prove that correct price has been used between related parties. It is also possible to ask for ruling (Advanced Pricing Agreement - APA) from the Hungarian tax authority.

In general, Hungary has a developed transfer pricing regulation that follows the OECD Transfer Pricing Guidelines. The following paragraph of Act on Corporate Tax includes reference to OECD TP Guidelines:

\textit{This Act contains regulations adopted with regard to the following documents in conformity with the Convention on the Organization for Economic Cooperation and Development (OECD) published by Act XV of 1998, including the related protocols and accession statements:}

\textit{a) model agreement on income tax and wealth tax;}

\textit{b) guidelines for international enterprises and for the tax authorities concerning the revision of prices between affiliated enterprises.}\textsuperscript{25}

If we recall the transfer pricing documentation requirements outlined by BEPS Action 13, we can see that the recommended documentation consist of 3 main elements:

- Master file - provides tax administrations with high-level information regarding MNE’s global business operations and TP policies
- Local file - detailed transactional TP documentation specific to each country
- Country-by-country (CBC) report - provides information about MNE’s operation and taxation in each jurisdiction where they do business. These information include:

\textsuperscript{24} Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 18 (1)

\textsuperscript{25} Act LXXXI of 1996 on Corporate Tax and Dividend Tax, Section 31 (2)
amount of revenue, profit before income tax, income tax paid and accrued, number of employees, state of capital, etc. Master file and local file already form part of the prescribed TP documentation in Hungary. Although, Country-by-country (CBC) reporting has not been introduced yet.

Despite the fact that transfer pricing rules are not hybrid-specific regulations, their absence could reinforce the negative effects caused by hybrid mismatch structures. Just let’s think about the tax consequences of an overpriced interest deduction by a hybrid entity! That is why it is essential to have powerful transfer pricing regulations.

**2.3.6 Impact of BEPS discussion on the Hungarian anti-avoidance legislation**

As we saw in the previous paragraph, Hungary has already introduced several anti-avoidance provisions and the repository of these rules has been gradually expanding. However, since the initiation of OECD’s BEPS project (2013) only one anti-avoidance provision has been phased in: the hybrid-related anti-avoidance rule that addresses tax treaty interpretation mismatches (2015).

![BEPS Discussion](image)

In fact, this “treaty override provision” plays an important role in tackling hybrid structures, but there has been no reference made to BEPS Action plan. The Hungarian government has not made any official statements in relation to BEPS so far. However, communication from the tax authorities indicates that the government welcomes the BEPS initiative.

**2.4 Exemplary case studies**

**Case 1**

After we have discussed the most relevant Hungarian provisions concerning hybrid entities and financial instruments, let’s examine some unclear cases from tax perspective. I will analyze how the Hungarian practice works in these situations in different roles. I will start the analysis with hybrid entities. The exhibited structure includes a hybrid entity (partnership) that falls under different tax treatment in countries S, P and R.
P is an entity established in State P. A and B are P’s partners who reside in State R. States P and S both treat P as a taxable entity while State R treats it as fiscally transparent. P earns royalty income from State S that is not attributable to a permanent establishment in State S.

Firstly, let's assume that Hungary is the source state of the interest/royalty income. In this case, each state claims to tax the concerned income:

- **State S (Hungary):** as the interest/royalty income was generated in Hungary, it has the right to impose withholding tax;
- **State P:** since P partnership is treated as a taxable entity in State P, it is considered to be a tax resident in State P. Therefore, State P has the right to impose CIT on P’s income;
- **State R:** since State R treats P partnership as a fiscally transparent entity, it assigns P’s income to its partners (A and B) who are tax residents in State R. Hence, State R claims to levy CIT or PIT (depending on the legal classification of the partners) on the received interest/royalty income by P partnership.

In order to reduce double taxation the P-S(HU) treaty is applicable. Since P partnership is a person liable to tax in State P, it is considered as a resident in State P according to the OECD Model Convention. In addition, as I wrote before, Hungary treats partnerships fiscally non-transparent from tax perspective. Hence, being a resident of one of the contracting states, P is entitled to the benefits of treaty P-S(HU). On the other hand, the treaty between State R and State S (Hungary) is not applicable, because under the domestic rules of Hungary P partnership is subject to tax and it does not see the partners behind the foreign partnership (P). In this case therefore, the received interest/royalty income will be taxable both in State P and State R. Although, State R can provide partners (A and B) credit for the taxes paid in State P under its domestic rules. However, we have to highlight at this point that Hungary does not impose withholding tax on dividend, interest and royalty payments to foreign entities under its domestic law. Thus, in terms of the amount of
withholding tax on passive income, it is not relevant which Convention is being used if Hungary is the state of source.

In contrast, OECD’s solution to this situation would be to grant the benefits of both the R-S and P-S Conventions and in case of different rates provided for in the two conventions, the lower should be applied. 6.5. paragraph of the Commentary on OECD Model Tax Convention on Article 1 provides the following:

“Where a partner is resident of one State, the partnership is established in an other State and the partner shares in partnership income arising in a third State, then the partner may claim the benefits of the Convention between his State of residence and the State of source of the income to the extent that the partnership’s income is allocated to him for the purposes of taxation in his State of residence. If, in addition, the partnership is taxed as a resident of the State in which it is established then the partnership may itself claim the benefits of the Convention between the State in which it is established and the State of source. In such a case of “double benefits”, the State of source may not impose taxation which is inconsistent with the terms of either applicable Convention; therefore, where different rates are provided for in the two Conventions, the lower will be applied.”

Now let’s examine, how would Hungary handle the concerned interest/royalty income in the role of state of residence of partners of the partnership (State R). In this case Hungary would treat P partnership as a regular taxable entity in State P, therefore it would allocate the income in question to P partnership, being taxable in State P. Due to this fact, Hungary would not impose tax on this income. In consequence, since all affected states treat P as a non-transparent entity, application of the tax treaty between State R (Hungary) and State S would not be possible. However, if P would forward the income obtained from “Company” to its partners (A and B), then Hungary would treat this income as a dividend; therefore it would levy CIT or PIT (depending on whether P’s partners are individuals or legal entities) on the mentioned income.

Evaluation

From state of source perspective: The outlined solutions were successful in preventing double taxation between State P and State S. We could see that both the Hungarian method and the OECD’s recommendation enabled to use the tax treaty between State P and State S. On the other hand, these methods were not able to resolve the double taxation situation between State P and State R. Both countries allocated the concerned income to their residents and imposed tax on it.

From state of residence perspective: The way in which Hungary handled P partnership and the received income proved to be efficient. The treatment of P partnership as a resident non-transparent entity in State P and allocation of the received interest/royalty income to P accordingly (instead of partners) made possible to avoid double taxation.

Case 2

To get more familiar with the treatment of hybrid entities by Hungary, let’s see another situation, where there is a mismatch among the tax treatment of different countries.

26 OECD (2014b) p. 49.
27 In general, received dividend is not taxable income of entities subject to corporate income tax.
P is an entity established in state P. A and B are P’s partners who reside in State R. States R and S both treat P as a taxable entity while State P treats it as fiscally transparent. P earns royalty income from State S that is not attributable to a PE in State S.

Let’s assume that Hungary is the state of source (State S) in the outlined situation. In this case only State S (Hungary) might claim to tax the interest/royalty income. Since P partnership is not liable to tax in State P, it is not considered as a resident in State P according to paragraph 1 of Article 4 of OECD Model Tax Convention. Consequently, the tax treaty between State P and State S (Hungary) is not applicable. Furthermore, due to the fact that State R treats P as a non-transparent resident entity of State P and allocates the received interest/royalty income to P, the tax treaty between State R and State S (Hungary) cannot be applied. Ultimately, without any applied tax treaty, State S (Hungary) will have the right to tax the concerned income without restriction. However, as Hungary does not impose withholding tax on dividends, interests and royalties the income in question will remain untaxed. As we can see, the Hungarian treatment of such structures is not effective, since it results in double non-taxation.

Case 3

After having discussed from different angles, how Hungary handles hybrid entities, let’s examine the treatment of hybrid financial instruments.
P is a corporation established in State P, R is a corporation established in State R. P issues a hybrid financial instrument to R. The instrument is treated as debt for the purposes of State P law, whereas state R qualifies it as being equity.

Firstly, let’s assume that Hungary is State P and P Co issues a hybrid financial instrument to R Co. In general, all payments carried out under this financial instrument is deductible by P Co in Hungary as long as the financial instrument is qualified as debt. However, there are some restrictions regarding the deduction:

1. The consideration paid to CFC shall not qualify as cost or expense incurred in the interest of business operations, unless the taxpayer is able to prove that it serves the purposes of his business operations. Thus, it may not be deducted from its pre-tax profit.\(^\text{28}\)

2. Thin capitalization rule: interest on debt (with the exception of receivables due from financial institutions) exceeding three times the taxpayer’s equity capital is nondeductible for corporate income tax purposes.

The most common financial instrument that use to be treated differently between countries is the interest-bearing share. According to the Act C of 2000 on Accounting\(^\text{29}\), the yields on interest-bearing securities shall be qualified as short-term liabilities, thus it forms a profit decreasing item. Since the Act on Corporate Tax does not include any other special provision regarding the deductibility of the yield of interest-bearing securities, it is deductible for Hungarian tax purposes. In consequence, if the jurisdiction of the payee party does not apply any anti-hybrid rules concerning hybrid financial instruments, a D/NI outcome may arise.

\(^{28}\) Schedule No. 3 to Act LXXXI of 1996 on Corporate Tax and Dividend Tax, A) 9.

\(^{29}\) Act C of 2000 on Accounting, Section 42, par. 3.
Now, let’s take a look at the other side of the situation, I will examine the way Hungary would treat a received payment under a hybrid financial instrument. As I highlighted before, a special anti-hybrid rule had been introduced to Hungary in 2012 to tackle hybrid mismatches deriving from hybrid financial instruments. This provision says that regardless the type of the financial instrument, payment that is deducted by the paying company, does not qualify as a dividend in Hungary according to the definition of dividend in the Act on Corporate Tax, therefore it shall be included in the ordinary income of the payee. For instance, those received payments under interest-bearing security that are deductible on the payer’s side, are part of the taxable income in Hungary. Application of this linking rule makes it possible to neutralise mismatch deriving from the different treatment of certain financial instruments.

After the examination of the Hungarian treatment of hybrid financial instruments from both sides, I will demonstrate OECD’s recommendation regarding hybrid financial instruments outlined in BEPS Action 2 deliverable. In order to neutralise the mismatch to the extent payment gives rise to a D/NI outcome, the report recommends a primary and a secondary (so-called defensive) rule:

1. **Primary rule:**
   
   “The payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/NI outcome.”

2. **Secondary (defensive) rule:**
   
   “If the payer jurisdiction does not neutralise 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.”

The secondary rule shall be applied when the payer jurisdiction does not deny deduction for payment in question (primary rule).

We may notice that the previously outlined Hungarian anti-hybrid provision corresponds to the secondary rule of OECD’s recommendation. However, we may not identify it as a consequence of the BEPS discussion, because it was introduced in 2012, just one year before the official OECD/G20 BEPS Project outset. Hungary has not made any official comments on OECD’s suggestions regarding hybrid financial instruments so far.

**Case 4**

Besides entities and financial instruments, hybrid mismatches may arise in case of dual consolidated companies as well. In our last case I will analyze how these companies are treated in Hungary.

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30 OECD (2014a) para. 65.
A Co is a company incorporated and tax resident in Country A. B Co a company incorporated in Country B but tax resident in both Country A and Country B. A Co holds all the shares in B Co. B Co owns all the shares in B Sub 1, a company tax resident and incorporated in Country B. B Co is consolidated, for tax purposes, with both A Co (under Country A law) and B Sub 1 (under B Country Law). B Co borrows from a bank and pays interest on the loan. B Co derives no other income.

Let's assume first that Hungary is State A. Recall that according to the Hungarian domestic law, the main criteria of becoming tax resident in Hungary for nonresident persons is to have their principal place of business management in Hungary. Therefore, if a foreign company becomes tax resident in Hungary, the same rules will apply to it than to those incorporated in Hungary: it will be subject to tax on its worldwide income. Although, as I emphasized before, submitting consolidated tax return is not possible in Hungary (only for VAT purposes). Hence, B Co in our example is not allowed to surrender its loss to A Co.

Secondly, I will analyze the tax treatment of the outlined situation, putting Hungary in the role of State B. If B Co is an incorporated entity being listed in paragraph 2 of Section 2 of Act LXXXI of 1996 on Corporate Tax and Dividend Tax, then it is considered as a tax resident in Hungary, thus it is subject to tax on its worldwide income. However, despite having a subsidiary in Hungary, it is not allowed to surrender its loss to B Sub 1. Even the members of the same group have to determine their tax bases and tax payable separately.

So as we could see, double-deduction of the losses of B Co may not arise from Hungarian perspective.

OECD has drawn up recommendations regarding dual-resident entities on two levels:

- On domestic level OECD recommends the following:

  “The following rule should apply to a dual resident that makes a payment that is deductible under the laws of both jurisdictions where the payer is resident and that DD outcome results in a hybrid mismatch:
Each resident jurisdiction will deny a deduction for such payment to the extent it gives rise to a DD outcome.”

- **On treaty level** OECD recommends to change Article 4 (3) of the OECD Model Tax Convention providing that cases of dual treaty residence would be solved on a case-by-case basis rather than on the basis of the current rule based on place of effective management of entities, which creates a potential for tax avoidance in some countries.32

Hungary has not made any official comments on OECD’s suggestions regarding dual-resident entities so far.

3. Hybrid mismatches and treaty law

In the first part of my paper, I’ve presented the current anti-hybrid rules in the Hungarian tax system, with a short outlook for other specific anti-avoidance rules (SAARs) and general anti-avoidance rule (GAAR). I’ve also demonstrated how do they work and analyzed how effective they are in tackling double taxation and double non-taxation through several cases.

Now, after having discussed all the details of the Hungarian domestic anti-hybrid toolbox, I will continue my research on treaty law concerning hybrid mismatches. If we recall Action 2 of the OECD BEPS Project, we can see that the report is split into two part: recommendations for domestic law and recommendations on treaty issues. In the coming chapters I will scrutinize the latter recommendations and their potential impact on the current Hungarian tax treaties. More specifically, I will elaborate on the two proposed modification in the OECD Model Tax Convention:

- **Dual resident entities**
- **Treaty provision on transparent entities**

The first proposed change aims to ensure that dual resident entities are not used for obtaining treaty benefits unduly. OECD recommends that cases of dual treaty residence should be solved on case-by-case basis rather than on the basis of the current rule based on place of effective management of entities, which creates a potential for tax avoidance in some countries. According to the final report of Action 2, Art. 4(3) of the OECD Model Tax Convention should be replaced by the following paragraph:

“Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent

and in such manner as may be agreed upon by the competent authorities of the Contracting States.\textsuperscript{33}

After realizing the threat posed by hybrid mismatches based on hybrid entities, OECD has published a report on The Application of the OECD Model Tax Convention to Partnerships in 1999 (Partnership report), which conclusion was used as a guidance in applying the Model Convention to partnerships. However, the Partnership report did not address the application of tax treaties to entities other than partnerships, and also some countries found it difficult to apply its conclusions. For these reasons - according to the OECD - enactment of a new provision is necessary to the Model Convention. The Final report of Action 2 of the OECD BEPS project would enact the following paragraph to Article 1:

“For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.”\textsuperscript{34}

We will see hereinafter, how this provision works in real situations and how efficient is in tackling hybrid mismatches. OECD’s report also contains recommendations on extending the current Commentary on Article 1 in order to provide guidance on how to apply the just quoted new provision.

The Hungarian government and tax authority have not made any comments on these two modifications yet. Publication regarding this topic is also really modest in Hungary.

3.1 Article 1 paragraph 2

The proposed new provision (paragraph 2) to Article 1 of the OECD Model Tax Convention currently is present only in one Hungarian tax treaty: the new treaty between the United States of America and Hungary, signed in 2010. However, we have to remark that this treaty has not entered into force yet due to restrained ratification from the American party.\textsuperscript{35} Despite of the fact that Hungary has signed several tax treaties with other major OECD member states in the recent years (e.g. Germany (2011), Great Britain (2011), Switzerland (2013)), none of them includes the recommended provision regarding transparent entities outlined in the Final report of Action 2.

I will provide a quotation of the Article 1 paragraph 6 of the mentioned new USA-Hungary tax treaty:

“6. An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of

\textsuperscript{33} OECD (2015a) p.137
\textsuperscript{34} OECD (2015a) p.139
\textsuperscript{35} Article 28 para 2 of this treaty says the following: “This Convention shall enter into force on the date of the exchange of instruments of ratification”
a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.\footnote{Convention between the government of the Republic of Hungary and the government of the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, Article 1 (6)}

If we compare this provision with the recommended paragraph 2 of Article 1, we can discover three major differences:

1. The quoted provision highlights “profit” and “gain” besides the “income” as falling under the scope of this provision. Conversely, the recommended para 2 of Article 1 names only “income”. However, if we take a look at the proposed extension of the Commentary on Article 1, it verifies that the word “income” also covers profits of an enterprise and capital gains.

   “26.9 The word “income” must be given the wide meaning that it has for the purposes of the Convention and therefore applies to the various items of income that are covered by Chapter III of the Convention (Taxation of Income), including, for example, profits of an enterprise and capital gains.”\footnote{OECD (2015a) p.141}

   In consequence, the two provisions have the same scope regarding items of income. We have to note that in the time of signing the treaty in question (2010), the recommended new paragraphs of Commentary on Article 1 by the OECD BEPS Project have not been available yet, therefore, they had to provide a more specific definition of income in the treaty itself.

2. A more important difference from our perspective on hybrid mismatches is the scope of the provision on entities. While the provision of the USA-Hungary convention applies solely to “entities”, the recommended rule by the OECD applies to “entity or arrangement”. That means that the USA-Hungary treaty is not applicable to trusts for example, only to entities. OECD’s provision however, is applicable to trusts as well:

   “26.8 The reference to “income derived by or through an entity or arrangement” has a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each Contracting State as to who derives that income for domestic tax purposes and regardless of whether or not that entity or arrangement has legal personality or constitutes a person as defined in subparagraph 1 a) of Article 3. It would cover, for example, income of any partnership or trust that one or both of the Contracting States treats as wholly or partly fiscally transparent.”\footnote{OECD (2015a) p.141}

3. Finally, the third important difference between the two provisions is the issue of transparency. As we can retrieve from the quoted provision of the USA-Hungary treaty, it is applicable to “an entity that is fiscally transparent under the laws of either Contracting State”. From this definition it is not obvious whether the provision is applicable to entities that are treated as partly fiscally transparent\footnote{Partly fiscally transparent entities can be for example Limited liability partnerships (e.g. German KG) or trusts. Certain countries treat one part of the income derived through trusts or limited liability partnerships as partly transparent.} under the
domestic law of one of the Contracting States. In contrast, the recommended Article 1 para 2 clearly clarifies that entities or arrangements that are treated as partly fiscally transparent fall under the scope of the provision.

All in all, taking these differences into account, we can conclude that the recommended Article 1 para 2 has a broader scope (including both wholly and partly fiscally transparent entities and arrangements) than the provision incorporated in the USA-Hungary convention.

Besides my analysis on Article 1 para 6 of the new USA-HUN treaty, we have to notice that there are four additional paragraphs in the Article 1 (excluding the general rule of paragraph 1). These provisions declare two important principles regarding the Convention:

- It shall not restrict in any manner any benefit accorded by the laws of either Contracting State;
- It shall not affect the taxation by a Contracting State of its residents and its citizens.

I found important to highlight these principles, because we can find the same idea outlined in the proposed extension of the Commentary on Article 1:

“26.16 As confirmed by paragraph 3, paragraph 2 does not restrict in any way a State’s right to tax its own residents. This conclusion is consistent with the way in which tax treaties have been interpreted with respect to partnerships (see paragraph 6.1 above).”\textsuperscript{40}

Recall, that at the time this treaty was signed (2010) the proposed extension of Commentary on Article 1 by the BEPS Project has not been available yet, thus laying out these principles were necessary within the treaty itself.

3.1.1 BEPS discussion’s impact on treaty legislation concerning hybrid entities

After the discussion of the provisions proposed by OECD BEPS Action plan, let’s examine how the Hungarian treaty-legislation has changed since the start of BEPS discussion. In terms of hybrid mismatches, OECD has recommended two changes in the OECD Model Tax Convention:

- Enactment of a new treaty provision on transparent entities (Article 1 para 2);
- Change in the arrangement of dual resident entities: these cases should be resolved on a case-by-case basis rather than on the basis of the current rule based on place of effective management (Article 4 para 3).

Regarding the first recommendation I have already emphasized that the new provision has been introduced only in one single Hungarian tax treaty: the new USA-Hungary convention. As this sole treaty with new Art. 1 para 2 was signed before the BEPS discussion, in 2010, we can state that the BEPS Project had no impact on this field of Hungarian treaty-legislation.

In order to determine the effect that BEPS discussion had on the Hungarian treaty-legislation regarding Article 4 para 3, I have conducted a research on the recently signed partnerships taxable at the level of the entity, while the other part of this income is treated taxable at the level of the partners/beneficiaries.

\textsuperscript{40} OECD (2015a) p.143
Hungarian treaties. My aim was to find out whether the Article 4 para 3 provision has changed significantly in the Hungarian treaties since the start of BEPS discussion (2013). The following chart provides an overview about how the recently signed Hungarian treaties resolve the issue of dual residency.

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contracting State</td>
<td>TW</td>
<td>RS</td>
<td>HM</td>
<td>US</td>
<td>AR</td>
<td>MX</td>
</tr>
<tr>
<td>Place of incorporation</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Place of eff. management</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Case-by-case</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

6. Table: Resolution of dual residency in the recent Hungarian treaties

As we can retrieve from the chart, Hungary has signed four tax treaties that solve the issue of dual resident entities on a case-by-case basis in the tested period. However, all of these conventions were signed in 2010 and 2011. In consequence, we can say that BEPS Discussion had no impact on the Hungarian treaty-legislation regarding Article 4 para 3.

3.1.2 Scope and binding effect of Article 1 (2)

As it was discussed before, the exact scope of the recommended Article 1 (2) provision (or the new USA-Hungary convention for instance) covers those income that is derived by or through an entity or arrangement which is treated as wholly or partly fiscally transparent under the law of either Contracting state.

Furthermore, this provision does provide for a binding effect of the qualification by the state of origin on the state of source. We can illustrate this binding effect through the example outlined in the Final report of BEPS Action 2:

“Example: State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.”

In this example we can see that regardless of State A’s classification of the interest-receiving entity, the convention was applicable to 50% of the interest-income derived by the

41 OECD (2015a) p. 140-141.
concerned entity. The treaty application was determined based on the entity’s qualification in State B.

3.1.3 Exemplary case studies

In order to illustrate the proposed provision’s potential impact on the tax treaties of Hungary in different situations, I will reexamine cases 1 and 2 from the analysis in the first part of my paper.

Case 1

As a reminder:

<table>
<thead>
<tr>
<th>State R</th>
<th>State P</th>
<th>State S</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>B</td>
<td></td>
</tr>
</tbody>
</table>

6. Figure: Case1

P is an entity established in State P. A and B are P’s partners who reside in State R. States P and S both treat P as a taxable entity while State R treats it as fiscally transparent. P earns royalty income from State S that is not attributable to a permanent establishment in State S.

At this case I have examined the Hungarian practice from two different perspective: from the source state role and the residence state role.

In the first instance (having Hungary as a source state) I have come to a conclusion that only S-P treaty is applicable for the interest/royalty income derived by P partnership due to the fact that P is considered as a resident only in State P. The S-R convention may not be used because P is not resident in State R. However, if S-R tax treaty would incorporate the proposed provision (Article 1 (2)) then this treaty would be applicable too in this situation. Under the provision, income derived by P shall be considered to be income of a resident of State R for the purposes of the convention because all of P’s partners are tax residents in State R. As the income in question is entitled to the benefits of both S-P and S-R conventions, Hungary could impose the lowest amount of withholding tax allowed under the two treaties. However, as I have indicated before, Hungary does not impose withholding tax on passive income under its domestic tax law.
Secondly, when I put Hungary to State R’s role, the conclusion was that only S-P convention could be used in terms of the interest/royalty income derived by P because Hungary would allocate the concerned income to P partnership. The inclusion of Article 1 para 2 to the S-R convention would not have any impact on the tax outcome because in this case all of the affected countries would treat P as a non-transparent entity.

Case 2

Now, let’s examine our second case of hybrid entities.

As a reminder:

<table>
<thead>
<tr>
<th>State R</th>
<th>State P</th>
<th>State S</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Company</td>
<td>B</td>
</tr>
</tbody>
</table>

**7. Figure: Case 2**

P is an entity established in state P. A and B are P’s partners who reside in State R. States R and S both treat P as a taxable entity while State P treats it as fiscally transparent. P earns royalty income from State S that is not attributable to a PE in State S.

If we recall, I have analyzed the tax outcome of the outlined case by putting Hungary to the source state’s role. The outcome was that neither S-P nor S-R treaty is applicable to the interest/royalty income derived by P because State P allocates the income to the partners and State R allocates it to the partnership. Therefore, without a convention applied, state of source has the opportunity to impose unrestricted withholding tax on this income. However, having Hungary as a source country will result in double non-taxation since Hungary does not impose withholding tax on passive income under its domestic tax rules. Even if the Article 1 para 2 would be implemented in Hungary’s tax treaties, double non-taxation would remain. The proposed provision affects only those conventions, where at least one of the contracting states treats the entity wholly or partly transparent. Hence, only S-P treaty could be influenced by Article 1 para 2, but since State P does not treat the interest/royalty income as income of its resident, it would not restrict State S in levying withholding tax.
3.1.4 Evaluation of Article 1 (2) provision in terms of hybrid entities

In the previous examples we could see that Article 1 para 2 had impact only at one case on the tax outcome. Even so, this provision plays an important role in aligning taxation rights among affected countries when it comes to hybrid entities. In order to illustrate the essence of this rule, let’s assume that partner B of partnership P from the previous case resides in State P and possess 50% share in P.

![Diagram](image)

*Figure: Case 2 (modified)*

The S-P convention without the proposed Article 1 para 2 provision may not be applied for the purpose of the income derived by P partnership because it is not subject to tax in State P, therefore P does not qualify resident in either contracting state. Thus, the withholding tax levied by State S on that income will not be restricted, moreover, State P will tax B partner’s income. We can see that half of the P partnership’s income was taxed twice: withholding tax by State S and CIT/PIT by State P.

The proposed provision by OECD can resolve this situation of double taxation very efficiently. If Article 1 para 2 have been included in the S-P treaty, then 50% of the income derived by P shall be considered to be income of a resident of State P for the purposes of this convention. In result, State S would be obliged to exempt 50% of the concerned income from withholding tax.

In my opinion this provision is an effective tool to solve some of the arising problems concerning hybrid entities. In the presented case, Article 1 para 2 could successfully eliminate the double taxation. However, double non-taxation can still arise due to beneficial domestic rules (see case 2).
3.2 Impact of BEPS discussion on current Hungarian treaties in general

After the discussion of the proposed modifications to the OECD Model Tax Convention by Action 2 of BEPS Action plan (Article 1 (2) and Article 4 (3)), I will analyze the impact of the other recommended modifications on the Hungarian treaty legislation.

In order to determine whether BEPS discussion had an influence on the recent Hungarian treaties, we have to select those actions from the Action plan that have formulated concrete recommendations regarding OECD MC’s text. The following two actions outlined the most exact suggestions regarding the OECD MC (Action 2 excluded):

1. **Action 6: Preventing the granting of treaty benefits in inappropriate circumstances**
   This action identifies **treaty shopping** as one of the most important sources of BEPS. Therefore, it recommends modifications to existing paragraphs and new provisions to OECD MC in order to curb treaty abuse:
   a. Title (Modification)
   b. Preamble (Modification)
   c. Article 1 paragraph 3 (New provision)
   d. Article 10 paragraph 2 (Modification)
   e. Article 13 paragraph 4 (Modification)
   f. Article 23 A paragraph 1 (Modification)
   g. Article 23 B paragraph 1 (Modification)
   h. Limitation of Benefits (LOB) clause (New provision)
   i. Principal Purpose Test (PPT) (New provision)

2. **Action 7: Preventing the artificial avoidance of PE status**
   The definition of PE is crucial in determining whether a foreign entity is taxable in a certain country. Nowadays, many companies exploit the loopholes that are present in the PE regulation and carry out business activity in a foreign country without having a permanent establishment. Action 7 proposes modifications to existing paragraphs of Article 5 of OECD MC in order to close these loopholes:
   a. Article 5 paragraph 4 (Modification)
   b. Article 5 paragraph 5 (Modification)
   c. Article 5 paragraph 6 (Modification)

Hungary has signed eight tax conventions since the beginning of BEPS discussion (2013). In order to determine BEPS Action Plan’s impact on the Hungarian treaty legislation I have collected all the conventions signed by Hungary from 2010 and indicated which modifications or new provisions proposed by the OECD are included in these treaties.
As we can retrieve from the chart, the only substantial change in the Hungarian treaty legislation since 2013 is that the new conventions incorporate a **Principal Purpose Test (PPT) Clause**. Most of the recently signed treaties include the exact text of the proposed provision by the final report of Action 6:

“\textit{Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in}”
that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.\textsuperscript{42}

In fact, this provision gives an efficient tool to tax authorities to prevent entities from obtaining treaty benefits unduly (treaty shopping). Furthermore, we can see that almost all of the new treaties express in their title and preamble that besides the avoidance of double taxation, preventing tax avoidance has the same importance for the purpose of the convention. However, treaties signed before 2013 have the same feature, therefore we may not attribute this character to the BEPS discussion.

### 3.2.1 Treaty interpretation and application

At the accession to the OECD, Hungary has agreed to join the organization’s documents, therefore OECD’s Commentary serves as an acknowledged guidance to the application of tax treaties. Hence, it determines the Hungarian practice regarding the implementation and interpretation of its conventions. In autumn 2014, the OECD has released a new version of the Model Tax Convention and the related Commentary. Subsequently, Hungarian Tax Authority (NAV) has issued an official announcement including that the new OECD Commentary is applicable in the interpretation of existing tax treaties from 1st of January 2015\textsuperscript{43}. The concerned 2014 Update incorporates a number of changes:

- Changes to Article 26 and its commentary;
- The application of Article 17 (Artists and sportsmen);
- Revised proposals concerning the meaning of “beneficial owner”;
- Revised discussion draft on tax treaty issues related to emissions permits and credits;
- Tax treaty treatment of termination payments;
- Technical changes to be included in the next Update to the Model Tax Convention.\textsuperscript{44}

However, we can find the following statement on the OECD website regarding the 2014 Update on Model Tax Convention and Commentary:

“The 2014 Update reflects work on the Model Tax Convention that was carried out between 2010 and the end of 2013; it does not, therefore, include any results from the ongoing work on the BEPS Action Plan.”\textsuperscript{45}

So we can see that the conclusions of the BEPS Action Plan has not been implemented in the OECD Model Tax Convention and its Commentary so far, therefore it is not present in the Hungarian tax treaty interpretation yet.

\textsuperscript{42} OECD (2015b) p. 55.
\textsuperscript{43} NAV (2015)
\textsuperscript{44} OECD (2014c)
\textsuperscript{45} OECD (2014c)
3.2.2 National Model Convention

Since Hungary does not have a national Model Convention it has not been changed due to the BEPS discussion. As an OECD member state, vast majority of the treaties signed by Hungary are based on the OECD Model Tax Convention. Hence, the planned modifications implemented in the OECD MC will influence Hungarian treaties signed in the future.

3.3 Implementation of the OECD Partnership report

Hungary interprets its tax conventions and treats different situations including partnerships in line with the principles set by the OECD Partnership report. As I have indicated before, OECD’s Commentary serves as an acknowledged guidance to the application of tax treaties in Hungary. Since the conclusions of the Partnership report have been incorporated in the OECD Model Tax Convention Commentary, they are considered at the interpretation of existing Hungarian treaties. However, there are some unique cases, when the Hungarian practice slightly differs from the practice appointed by OECD (see case 1).

“2. Domestic laws differ in the treatment of partnerships. These differences create various difficulties when applying tax Conventions in relation to partnerships. These difficulties are analysed in the report by the Committee on Fiscal Affairs entitled “The Application of the OECD Model Tax Convention to Partnerships”, the conclusions of which have been incorporated below and in the Commentary on various other provisions of the Model Tax Convention.”

The partnership report have not been discussed particularly among scholars, administration or jurisdiction.

3.3.1 Changes in implementing and applying the principles set by the Partnership Report since the BEPS discussion came up

Due to the fact that, the conclusions of the BEPS discussion have not been implemented in the OECD Model Tax Convention Commentary so far, there have not been any changes in implementing and applying the principles set by the partnership report yet.

3.4 Implementation through multilateral instrument

The severity of BEPS requires a fast reaction. This is the main reason why the actions of the BEPS Project have been assigned such a short deadline. Recommendations concerning domestic rules and Model Convention provisions outlined by the OECD can help countries to tackle tax evasion. However, timing plays an important role in the implementation of these changes. While introducing new rules to the domestic tax system can bring the desired results in relatively short time, the implementation of the recommended changes in the bilateral tax treaties are way more difficult. If a state intends to implement the

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46 OECD (2014b) p. 49.
proposed provisions in its treaties, then renegotiating each convention can take up many years until the impact of these measures will be visible. OECD has also recognized this problem, and came up with a multilateral instrument solution. Creating a multilateral instrument that countries can join to, may speed up the implementation process of the recommendations concerning treaties outlined in different BEPS Actions (2, 6, 7). That is why creating a multilateral instrument is crucial to achieve visible results in curbing BEPS. In terms of hybrid mismatches, if a state joins to the multilateral instrument, its bilateral treaties with those countries that have also joined the foregoing instrument, would automatically include the recommended Article 1 (2) provision and the modification of Article 4 (3). Hungary supports the development of such instrument, however, the government have not issued any official statement regarding this topic so far.

3.4.1 Advantages and disadvantages of multilateral instrument concerning the topic of hybrid mismatches

There are many advantages of implementing the recommended treaty provisions through a multilateral instrument. The Final report of BEPS Action 15 names the following benefits:

- Changes to the OECD Model Tax Convention are intended to ultimately produce changes to the network of bilateral tax treaties that form a key component of the broader international tax architecture;
- A multilateral negotiation can overcome the hurdle of cumbersome bilateral negotiations and produce important efficiency gains;
- The multilateral instrument can provide developing countries with the opportunity to fully benefit from the BEPS Project;
- Some issues are much easier to address multilaterally than in bilateral instruments;
- A multilateral instrument can increase the consistency and help ensure the continued reliability of the international tax treaty network, providing additional certainty for business.\(^\text{47}\)

As a result, the recommended provisions concerning hybrid mismatches can become part of the tax treaty architecture in a quicker way, enabling countries to tackle tax structures building on hybrid mismatches.

On the other hand, modification of the current tax treaty architecture needs careful attention: technical issues may occur between the bilateral tax treaties and the multilateral instrument, such as preserving national sovereignty over bilateral treaties. Furthermore, broad participation will be needed to implement the multilateral instrument efficiently. Around 90 countries participate currently in the development of the multilateral instrument, however, it does not lead to commitment to sign it. For instance, United States seems not to participate in the multilateral instrument, because its treaties have already incorporate the proposed provisions by the OECD.\(^\text{48}\) We have to remember that the multilateral instrument will be binding only to those bilateral tax treaties, where both of the contracting states have joined the instrument.

\(^{47}\) OECD (2015c) p. 18-19.

\(^{48}\) Lee A. Sheppard and Stephanie Soong Johnston (2015)
4. Impacts of European Union Law on the discussion on hybrid mismatches

4.1 Compatibility with EU law

After having discussed the BEPS Action plan’s recommendations regarding hybrid mismatches from both domestic tax law and treaty perspective, I will turn to examine the impact of European Union Law on the discussion on hybrid mismatches. Since Hungary has been EU member for twelve years, it is important to analyze the potential changes in tax legislation from EU point of view as well. Despite the involvement of the European Commission in the development of BEPS recommendations, issues may still arise regarding the interaction between EU Law and proposed domestic provisions. EU law impose an important limit on measures against tax avoidance in the interest of internal market.

In contrast to the indirect taxation, direct taxation is not harmonized within the EU, it remains almost the sole responsibility of the member states. The creation of directives and regulations in the area of direct taxation is in principle subject to unanimous approval of all member states.\(^{49}\) As a result of lack of consensus, harmonization through statutory instruments in the area of direct taxation has been limited. However, some steps have been taken through directives such as Parent-Subsidiary Directive, Merger Directive or Interest and Royalty Directive. Due to the limited positive harmonization measures, the EU Court of Justice has taken a leading role of developing the internal market from a direct tax perspective by prohibiting member states’ tax provisions which are contrary to the internal market principles of the EU, in particular the four freedoms.\(^{50}\)

The four freedoms of the internal EU market are the following:

- Free movement of goods
- Free movement of services
- Free movement of persons
- Free movement of capital

These fundamental freedoms prohibit the discrimination based on nationality or residence. Member states’ provisions may not affect investment and employment decisions neither.

Article 107 (1) of the Treaty on the Functioning of the European Union (TFEU) declares the following:

“Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.”\(^{51}\)

This paragraph qualifies as a powerful tool in prohibiting measures that provide advantages to certain undertakings or to certain group of undertakings. So as we can see,

\(^{49}\) Art. 114 (2), Art 115 TFEU  
\(^{50}\) Prof. Dr. Sjoerd Douma (2015)  
\(^{51}\) Art. 107 (1) TFEU
regardless of unharmonization of direct taxation, European Union still have some tools to keep the member states’ rules within the frame of internal market.

In order to determine whether the Hungarian regulation concerning hybrid entities is compatible with EU-law, recall our cases on hybrid entities from part I.

Case 1

In our first case, I have presented the Hungarian solution from the source state’s perspective. In the illustrated example, Hungary (State S) - enables to apply the S(HUN)-P treaty, since the beneficiary of the interest/royalty transaction (P partnership) is a tax resident in State P, therefore it is entitled to the benefits of the S-P treaty. On the other hand, S-R convention is not applicable, because Hungary (State S) sees only P partnership as a beneficiary in relation to the interest/royalty payment and P partnership does not classify resident in State R.

As a result, P’s partners who reside in State R, are not able to get the benefits of the S-R treaty. However, if P partnership would have partners who are tax residents in State P, then they would be in advantageous position compared to those who reside in State R because they could obtain the benefits of S-P treaty. This fact raises compatibility issues with the freedom of establishment as partners of State R and partners of State P are not treated equally from tax perspective. However, there is no discrimination in practice since Hungary does not levy withholding tax on cross-border interest/royalty payments.

After we have analyzed the first case from EU-law perspective, I will scrutinize our second case relating hybrid entities.
In this case I have investigated Hungary’s practice in the role of the source state (State S). The conclusion of my investigation was that neither S-P nor S-R convention can be applied, therefore Hungary (State S) has the right to impose withholding tax on the concerned interest/royalty income. However, since Hungary does not impose withholding tax on passive income under its domestic tax rules, the income remains untaxed - double non-taxation occurs.

From EU-law point of view, Hungary has not violated any fundamental freedoms because none of the parties have been discriminated based on their nationality or residency. Furthermore, the Hungarian practice is in line with the Interest & Royalty Directive\textsuperscript{52} which declares that EU member states has to eliminate the withholding tax obstacles regarding cross-border interest and royalty payments within a group. However, if we change the case slightly by having partner B resided in State P, the situation becomes more difficult.

\textsuperscript{52} 2003/49/EC
While partner A enjoys the double non-taxation of its share from P’s income due to hybrid mismatch (and the absence of withholding tax in Hungary (State S)), partner B’s part of the partnership’s income will be taxable in State P in the hand of partner B. As a result, the two partners of the same partnership have been treated differently due to their different residency. Therefore, the outlined treatment is not compatible with the freedom of establishment. To establish a partnership in State P and derive income from a third state (State S) is more beneficial for residents of State R than residents of State P. Based on this fact we can state that it distorts the internal market.

Now, let’s recall our third case that introduced the treatment of payments under hybrid financial instruments from a Hungarian perspective.

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53 Article 49 TFEU
Firstly, we put Hungary to the role of the source state (State P). Under the Hungarian domestic rules the payment on debt is deductible at the payor (P Co) for tax purposes. Secondly, I have examined the treatment of the concerned payment from the payee (R Co) perspective. In general, the received dividend is not liable to tax in Hungary in order to prevent economic double taxation. However, the definition of the dividend has been changed in 2012. Since then, only those received dividend payments are exempt from taxation that have not been deducted from the payer’s tax base.

If we put this case to EU perspective, we can see that there is no discrimination against non-resident entities in terms of the Hungarian treatment. Being a source state, Hungary allows the deduction of the payment on debt regardless of the residency or nationality of the payor. Also, as a state of residence, Hungary grants the same benefit on received payments regardless of the nationality or residence of the payee party. Therefore, the Hungarian regulation is in line with the fundamental freedoms of the internal market since there is no differentiation made between domestic and other EU citizens or residents. What is more, if we take a closer look to the Hungarian treatment of received dividends, it is visible that it is consistent with the amended Parent Subsidiary Directive\textsuperscript{54}, which points out that parent company’s state shall deny the exemption of such a payment that was deducted from the subsidiary’s tax base.

Case 4

Finally, the last case that I will examine from EU-law point of view is the case of hybrid mismatch caused by dual-resident entities.

\textsuperscript{54} COM(2013) 814
In the first part of my paper, I have pointed out that under Hungarian domestic rules there is no tax consolidation available for the purposes of corporate income taxation. Therefore, dual-resident entities have not got possibility to surrender their loss to other related company. All entities have to determine their tax base separately.

This practice is not contrary to the EU-rules, because the domestic regulations are binding on both residents and non-residents equally. Hungarian entities that belong to the same group shall not determine their tax bases on a consolidated basis neither.

4.1.1 Compatibility with EU law after the implementation of Article 1 (2)

In the previous chapter we have examined the four notable cases from EU law compatibility perspective and it turned out that there are some cases when the current Hungarian treatment of hybrid mismatch situations may raise compatibility issues. Throughout part I. and part II. of my paper I have demonstrated the recommended changes by the OECD to domestic regulation and Model Tax Convention. Hence, it is reasonable to examine the compatibility of post-BEPS Hungarian practice with EU law, particularly with the four freedoms. If we recall the case analysis carried out in part II. of my paper, we shall remember that we had two cases where change was observed in tax outcome between the current practice and post-BEPS practice. For this reason, I will concentrate on these two cases in the analysis of compatibility with EU law.

13. Figure: Case 4

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Case 3

In the first case, we have concluded that only S(HUN)-P treaty is applicable under the current Hungarian practice. Also, this implementation may raise EU-law compatibility issues since partners with residence in State R fall under different treatment from tax perspective than those of State P. However, in Part II of my paper I have indicated that adoption of Art 1 (2) provision in the S(HUN)-R treaty may change the outcome of the case. The recommended rule would entitle the partners of P who are residents of State R to the benefits of the S(HUN)-R convention. As a result, both S(HUN)-R treaty and S(HUN)-P treaty would be applicable, therefore all partners (with residence in State R and State P) could get the same treaty benefit. From EU-law point of view, we can identify Art 1 (2) provision as an efficient tool in eliminating compatibility issues in the outlined situation, but only in those cases when the state of source levies withholding tax on the payment under its domestic rules. Since Hungary does not impose withholding tax on cross-border interest and royalty payments, the implementation of Article 1 (2) provision in the S(HUN)-R convention will not have significant impact in practice.
In the other case we had a partnership (P) incorporated in State P and its two partners who share equally its income. However, the two partners are residents of different states: while partner A is tax resident in State R, partner B is resident in State P. Although State P treats P partnership as fiscally transparent, States S and R treat P as an opaque entity for tax purposes.

Under the current practice - as we have highlighted beforehand - neither S-P nor S-R treaty is applicable. As Hungary (State S) under its domestic rules does not levy withholding tax on the concerned interest/royalty income, none of the countries will tax partner A’s share of income. On the other hand, since State P allocates half of the income derived by P partnership to partner B, it will be liable to tax in State P at the level of the partner. In consequence, we have concluded that the outlined treatment is contrary to the freedom of establishment.

However, implementing the recommended Article 1 (2) provision in tax treaties would change the taxation rights in the outlined structure. If the proposed article would have been incorporated in the S-P treaty, then partner B’s share of the income (50%) derived by P shall be considered to be income of a resident of State P for the purposes of this convention. As a result, State S would be obliged to exempt 50% of the income from withholding tax. As we can notice, Article 1 (2) provision will only influence the tax outcome of the outlined structure if the income in question is subject to withholding tax in the source state (State S) under its domestic rules. Since Hungary does not levy withholding tax under its domestic rules, tax outcome of this structure will not change by introducing Article 1 (2) provision to S(HUN)-P treaty. As a result, partner B will remain discriminated against partner A, who has not been taxed after his income derived by P partnership. So we can conclude that implementing the recommended provision in the tax treaties would not change the fact that the outlined solution is contrary to the freedom of establishment principle.
4.1.2 Compatibility with EU law of the current Hungarian anti-avoidance structures regarding hybrid mismatches

In the previous chapter we have examined whether Hungarian treaty-legislation is contrary to the EU-law. Now, I will scrutinize the Hungarian domestic anti-hybrid rules from EU-law point of view. In the first part of the paper I have mentioned that currently there are two major anti-hybrid provisions in the Hungarian tax system.

The first rule of such kind aims to eliminate the negative effects of hybrid financial instruments. Since the modification of the definition of dividend\(^{55}\) in 2012, those received payments that have been deducted from the payer’s pre-tax profit shall not classify as dividends and therefore may not be exempted from taxation in Hungary. Through the cases in the beginning of Part III I have pointed out that this provision is in line with EU-rules. What is more, we can interpret it as the Hungarian implementation of the amendment of Parent-Subsidiary Directive. I will elaborate on this directive in detail through the next chapter.

The second Hungarian anti-hybrid provision was introduced in 2015 and it concerns mismatches caused by hybrid entities. This treaty override rule aims to address those situations, when none of the contracting states treat the income as taxable due to the available facts or due to different interpretation of the tax convention. In such case, this provision entitles Hungary to refuse granting exemption to the concerned income. I will examine the compatibility of this rule with EU-law through an example.

**16. Figure: Case of hybrid PE**

Assume that a Hungarian company (Hu Co.) carries out business activity in an other EU member state and derives income from this state. The HUN-EU_MS tax treaty classifies Hybrid PE as a PE and assigns taxation right to EU MS. On the other hand, state of source (EU MS) does not recognize the concerned income to be derived by a PE under its domestic tax rules, therefore it does not impose tax on it. As a result, none of the countries will levy tax on the income derived by Hybrid PE. In case of such mismatch, the mentioned Hungarian provision override the treaty resolution and entitles Hungary to deny exemption of the income derived by Hybrid PE.

\(^{55}\) Act LXXXI. of 1996 on Corporate Tax and Dividend Tax, Section 4, 28/b
Regarding permanent establishments we have to note that under the freedom of establishment principle, business activity carried out in an other Member state may not be treated adversely compared to locally incorporated companies. However, the different definition of PE in the treaty and domestic rules of EU MS resulted in double non-taxation. In consequence, Hybrid PE was treated more favorably from tax perspective than locally incorporated companies under the domestic rules of EU MS. The Hungarian rule just aims to eliminate this double non-taxation by bringing back the concerned income under taxation. Due to the fact that the concerned provision gets activated only under double non-taxation circumstances, it qualifies compatible with the freedom of establishment principle. As the mentioned provision has been present in the Hungarian tax system only since 2015, there have not been any court-cases regarding this rule yet. Based on the outlined case, we can see that hybrid PE mismatches could be eliminated in the internal market by unifying the definition of permanent establishment in all member states.

4.2 Changes in EU law since the BEPS discussion came up

4.2.1 Directives

As I have indicated in the introduction of Part III, harmonization in the field of direct taxation is limited due to the fact that creation of directives requires unanimous approval of all member states. However, EU member states could agree on some directives affecting direct taxation:

- **Parent Subsidiary Directive** (since 1990) - eliminates the double taxation of dividends paid by a subsidiary located in a member state to parent company situated in other member state;
- **Merger Directive** (since 1990) - governs the treatment of the distribution of profit at mergers;
- **Arbitration Procedure Convention** (since 1990) - introduces policies for settling disputes regarding income of associated companies in different member states;
- **Interest & Royalty Directive** (since 2003) - eliminates the withholding tax on interest and royalty payments by a subsidiary located in a members state to a parent company situated in other member state.

Since the beginning of the BEPS discussion the number of initiatives for directives concerning direct taxation has speeded up. First, the European Commission submitted a proposal for a directive\(^5\) in 2013 which goal is to amend the existing Parent Subsidiary Directive. This amendment introduces two important provisions:

- **Hybrid provision**: the parent company shall not exempt those payments that have been deducted from the subsidiary’s tax base;
- **General anti-abuse rule**: the benefits of the Parent Subsidiary Directive may not be granted if a corporate structure is set up for the main purpose of obtaining tax benefits.

Member states had to translate these recommended provisions into their tax systems by the end of 2015.

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\(^5\) COM(2013) 814
In order to increase tax transparency among member states, the EU Commission came up with a **Tax Transparency Package** that includes proposal for a directive on the automatic exchange of information in the field of taxation\(^{57}\) and the communication on tax transparency to fight tax evasion and avoidance\(^{58}\).

In addition, adjusted with the conclusions of the OECD BEPS Project, EU Commission has come up with a strategy for re-launching the proposal of the **common consolidated tax base (CCTB)** in 2016. The CCTB will address the tax-avoidance structures that exploit the regulatory gaps between national systems.\(^{59}\)

![Figure: BEPS discussion's impact on EU legislation concerning direct taxation](image)

It is visible from the illustration that the BEPS discussion had a substantial impact on creating new directives concerning direct taxation in the European Union.

### 4.2.2 General changes in EU law

Besides creating and proposing new directives, EU has started to use other tools as well for countering tax avoidance and aggressive tax planning. In the recent years we could notice that the European Commission has conducted several **state aid investigations** concerning tax rulings provided by some member states to MNEs. This points out that besides preferential tax legislation, state aid can be granted through preferential administrative practice as well. MNEs often apply for tax rulings or advance pricing agreements (APA) to obtain legal certainty for the tax outcome of their tax structures or transactions. Although, if the tax ruling issued by a member state deviates from the normal application of law and enables the beneficiary to shift its profit to low tax jurisdictions or just simply decrease its tax burden then it constitutes state aid. Therefore, state aid rules constitute a powerful tool in tackling tax avoidance and aggressive tax planning.\(^{60}\) It may be even more deterrent if we consider that in case of unlawful state aid, the EU Commission can require the recovery of the aid from the beneficiary company with respect to the last 10 years plus interest.

Since 2014, the application of EU State aid law to member states' tax ruling practices has become priority for the Commission. In June 2014, European Commission conducted in-

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\(^{57}\) COM(2015) 135

\(^{58}\) COM(2015) 136

\(^{59}\) Doris Kolassa (2015)

\(^{60}\) Lang et al. (2016) p. 49.
depth investigations concerning transfer pricing arrangements on corporate taxation of Starbucks (NL), Apple (IRL) and Fiat Finance and Trade (LUX). Four months later it started investigation on the TP arrangement of Amazon in Luxembourg. The benelux country got its next state aid investigation in 2015, when the Commission’s preliminary view was that the tax ruling granted by Luxembourg may have granted McDonald’s an advantageous tax treatment. The most recent conclusion of the Commission was that the Belgian “Excess profit” tax scheme qualifies illegal in terms of state aid law. Due to this decision, around 700 million € shall be recovered from 35 multinational companies. As we can see, the Commission has started to utilize its state aid law to counter tax avoidance and aggressive tax planning. This measure may stimulate MNEs to use less aggressive tax structures within the EU market.

In addition, the **Code of Conduct Group for Business Taxation** that was established in 1997 with aim to address harmful tax competition, has also taken measures since the beginning of the BEPS project. In the end of 2013, it was mandated by the ECOFIN to review the “substance” requirement in the Code and assess all the patent boxes in the European Union taking into account the OECD BEPS initiative as well. In 2013 an **Anti Abuse Subgroup** was created that works on hybrid mismatches and reports to Code of Conduct group.

### 5. Conclusion

In the first part of my paper I have pointed out that currently there are two major anti-hybrid rules in the Hungarian tax system: the definition of the dividend (against hybrid financial instruments) and a general anti-avoidance rule aimed at hybrid entities. These rules make the Hungarian tax system the most advanced in the V4 region in the field of anti-hybrid rules.

In the second part of the paper I have introduced the recommendations of Action 2 of the BEPS project regarding the OECD Model Tax Convention: the proposed Article 1 (2) provision and the recommended modification concerning Article 4 (3). I have conducted a research on the recently signed Hungarian tax conventions in order to size up the impact of the BEPS discussion on the Hungarian treaty-legislation. The result of the research reveals that the recommendations outlined in the final report of Action 2 has not caused any change in the Hungarian treaty-legislation so far. Besides these two hybrid recommendations I have also examined the other action’s potential effect and I find out that the most significant change has been the incorporation of the Principal Purpose Test (PPT) clause in the Hungarian treaties signed since the BEPS discussion came up. After the examination of recent treaties I have introduced the Hungarian practice in treaty interpretation and application through several case studies. Based on these exemplary case studies, I concluded that Article 1 (2) provision is an effective tool to solve some of the arising problems concerning hybrid entities. In the presented case, Art 1 (2) could successfully eliminate double taxation. However, in certain cases double non-taxation may remain due to beneficial domestic rules.

In the last part of my paper I have analyzed the current Hungarian practice regarding hybrid entities and hybrid financial instruments from EU-law perspective. I have highlighted
that at two of the examined cases compatibility issues may emerge in connection with the fundamental freedoms. It was also important to analyze the potential impact of the implementation of the proposed provisions. The outcome of my research showed that even though the proposed provisions help to ensure the compatibility with EU law in many cases, it will not change the tax outcome of the Hungarian cases due to the absence of withholding tax in Hungary. The last chapter of the third part of my paper pointed out that the proposals of new directives regarding direct taxation speeded up significantly since 2013. Moreover, the EU Commission started to use state aid rules as a tool against tax avoidance and aggressive tax planning.

Despite of the fact that Hungary has the most developed anti-hybrid regulation in the V4 area, there is still lot to do in this field. Most of the recommended domestic provisions outlined in the Action 2 of BEPS Action plan are still waiting for introducing. The same statement applies to the Hungarian treaties too. However, in fact, these proposed provisions has been incorporated in the treaties of just a few countries so far. Based on the efforts made by the European Union to tackle tax evasion, it is conceivable that the member states will be stimulated to introduce the recommended measures by OECD through future directives.
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