EU Finance Ministers reach an agreement on ATAD 2 targeting hybrid mismatches

*By Oliver R. HOOR, Keith O'DONNELL (pictures) and Samantha SCHMITZ-MERLE, Atoz **

On 21 February 2017, the EU Finance Ministers agreed during a meeting of the ECOFIN[1] on a compromise proposal for an EU Directive amending Directive (EU) 2016/1164 (the so-called Anti-Tax-Avoidance-Directive, "ATAD"). While the ATAD already included measures dealing with hybrid mismatches in an EU context, ATAD 2 replaces these rules and extends their scope to transactions involving third countries. The EU Council is expected to adopt ATAD 2 once the European Parliament has given its opinion. This article outlines the hybrid mismatches targeted by the directive, the mechanisms that should avoid mismatch outcomes and the areas where ATAD 2 should have no impact.

I. Introduction

ATAD 2 follows the recommendations of the OECD in regard to Base Erosion and Profit Shifting (BEPS) Action 2 (Hybrid mismatch arrangements) and covers a number of hybrid mismatches such as financial instrument mismatches, hybrid entity mismatches, reverse hybrid mismatches and permanent establishment mismatches.

In general, a hybrid mismatch structure is a structure where a financial instrument, an entity or a permanent establishment is treated differently for tax purposes in two different jurisdictions. Hybrid mismatch may lead to situations in which (i) a payment is deducted in two jurisdictions, (ii) a payment is deductible in one jurisdiction and not taxed in the other jurisdiction or (iii) to a situation in which income is not taxed at all (in accordance with the domestic tax laws of the jurisdictions involved).

In case there is a hybrid mismatch with a third state, ATAD 2 places the responsibility to neutralize the effects of hybrid mismatches on the EU Members States. This entails that EU Member States have to deny the deduction of payments or have to include income that would otherwise not be taxed in the third state.

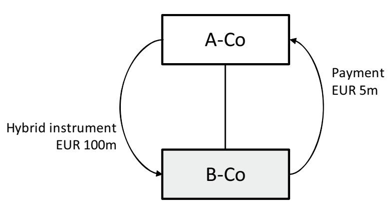
II. Hybrid mismatches covered by ATAD 2

ATAD 2 has a broad scope and addresses the following types of hybrid mismatch situations:

- **Hybrid mismatches that result from payments under a financial instrument;**

Example: Hybrid financing instrument mismatch

A company resident in State A (A-Co) finances its subsidiary resident in State B (B-Co) with a EUR 100m financing instrument that is treated as equity in State A, whereas the instrument is treated as debt in State B.

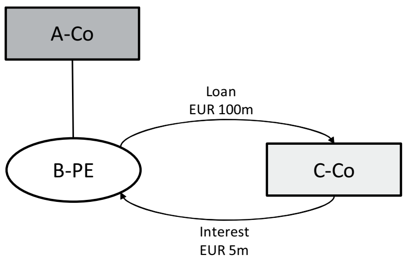


At the level of B-Co, the interest payments of EUR 5m are tax deductible, whereas at the level of A-Co the dividend income benefits from a tax exemption.

- **Hybrid mismatches that are a consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment (PE), including situations where payments made to a disregarded PE are not taxed at the level of the head office;**

Example: Hybrid PE mismatch leading to a deduction without inclusion

A company resident in State A (A-Co) performs financing activities through a PE situated in State B (B-PE). Although the PE is recognized under the domestic tax law of State A and the applicable tax treaty concluded between State A and State B, under the domestic tax law of State B the PE of A-Co is not recognized for tax purposes. A-Co grants a loan of EUR 100m via B-PE to C-Co, an associated enterprise resident in State C.

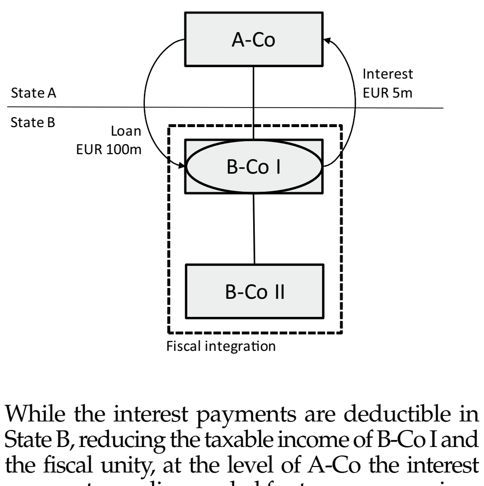


While the interest payments are deductible at the level of C-Co, State B does not tax the interest income as no PE is recognized under domestic tax law of State B. At the same time, State A exempts the income realized through B-PE in accordance with the applicable tax treaty. Hence, the income is tax deductible in State B and not taxable or tax exempt, respectively, in State A and State B.

- **Hybrid mismatches that result from payments made by a hybrid entity to its owner or deemed payments between the head office and PE or between two or more PEs;**

Example: Hybrid entity mismatch leading to a deduction without inclusion

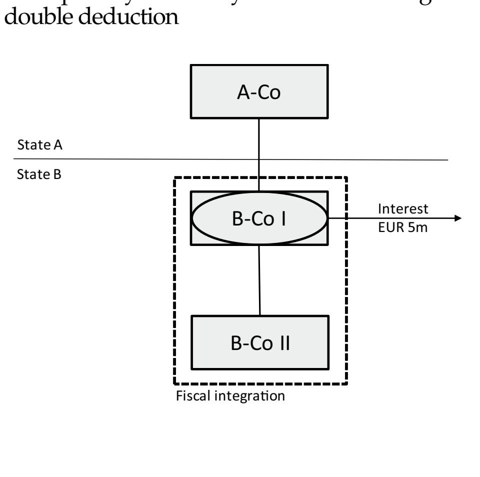
A company resident in State A (A-Co) finances its subsidiary in State B (B-Co I) with a loan of EUR 100m. While B-Co I is treated as a transparent entity from the perspective of State A, under the domestic tax law of State B, B-Co I is treated as an opaque entity. B-Co I formed a fiscal unity with B-Co II a subsidiary resident in State B.



While the interest payments are deductible in State B, reducing the taxable income of B-Co I and the fiscal unity, at the level of A-Co the interest payments are disregarded for tax purposes since such transactions are disregarded between a transparent entity and the owners thereof.

- **Double deduction outcomes resulting from payments made by a hybrid entity or PE.**

Example: Hybrid entity mismatch leading to a double deduction



A company resident in State A (A-Co) has a subsidiary in State B (B-Co I). B-Co I receives funding from a third party. In this regard, B-Co I pays interest of EUR 5m.

While B-Co I is treated as a transparent entity from the perspective of State A, under the domestic tax law of State B, B-Co I is treated as an opaque entity. B-Co I formed a fiscal unity with B-Co II a subsidiary resident in State B.

In this case, the interest payments are deductible at the level of B-Co I and A-Co, resulting in a double deduction due to the hybrid entity classification.

III. Mechanism for tackling mismatch outcomes

ATAD 2 provides for the following mechanisms to tackle mismatch outcomes:

- **Double deductions**

Where a hybrid mismatch results in a double deduction, the deduction shall be denied in the Member State that is the investor jurisdiction. As a secondary measure, ATAD 2 provides that in case the deduction is not denied in the investor jurisdiction, the deduction shall be denied in the Member State that is the payer jurisdiction.

- **Deduction without inclusion**

Where a hybrid mismatch results in a deduction without inclusion, it is stated that the deduction shall be denied in the Member State that is the payer jurisdiction.

As a secondary measure, the directive provides that if the deduction is not denied in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome shall be included in the income in the Member State that is the payee jurisdiction. With regard to the latter rule, Member States have the option to not apply the secondary rule to certain types of hybrid mismatches.

- **Reverse hybrid mismatches**

ATAD 2 also provides for a rule that targets so-called reverse hybrid mismatches. When an entity is established in a Member State and treated as transparent for tax purposes, whereas at the level of the non-resident owners of the entity[2], the latter is treated as opaque, the income might benefit from double non-taxation.

In these circumstances, the hybrid entity shall be regarded as a resident of the Member State and taxed to the extent the income is not taxed otherwise under the laws of the Member State or any other jurisdiction.

- **Tax residency mismatches**

Last but not least, ATAD 2 provides for a rule that deals with situations where an entity is deemed to be resident in two or more jurisdictions and expenses are deductible in both jurisdictions.

Here, the directive states that a Member State involved shall deny the deduction to the extent that the other jurisdiction allows the duplicate deduction to be set-off against income (that is not dual-inclusion income[3]). Where both jurisdictions are Member States, the Member State where the taxpayer is deemed "not" to be resident in accordance with an applicable tax treaty shall deny the deduction.

III. Where ATAD 2 should have no impact

It is interesting to note that the guidance provided in the ATAD 2 clarifies a number of issues in relation to the scope and the application of the rules on hybrid mismatches. ATAD 2 states that the rules provided therein should only apply to "deductible payments".

Hence, unless otherwise stated, the rules only apply to payments; not for example to provisions recorded in relation to financing instruments. The payment further needs to be deductible, excluding non-deductible payments from the scope of ATAD 2.

Moreover, as jurisdictions use different tax periods and have different rules for recognizing when items of income or expenses have been derived or incurred, ATAD 2 stresses that these timing differences should generally not give rise to hybrid mismatches as long as the income is included within a reasonable period of time. According to the Directive, a payment under a financial instrument shall be treated as included in income within a reasonable period of time where

- the payment is included by the jurisdiction of the payee in a tax period that commences within 12 months of the end of the payer's tax period; or
- it is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future period and the terms of the payment are consistent with the arm's length principle. Thus, when a timing difference exceeds the aforementioned 12 month period, taxpayers should be free to evidence that the payment will be included in a future period.

ATAD 2 further confirms that any adjustments required in accordance with the Directive should in principle not affect the allocation of taxing rights between Contracting States under applicable tax treaties. This statement acknowledges that treaty law is generally superior to the domestic tax laws of the Contracting States.

In addition, the guidance confirms that transfer pricing adjustments should not fall within the scope of a hybrid mismatch.

Last but not least, the Directive provides for a carve-out from the rules when it comes to hybrid regulatory capital. This is of particular importance for the banking sector which has to comply with certain solvency criteria. However, this carve-out should be limited in time until 31 December 2022. With regard to financial traders, a delimited approach is followed in line with that followed by the OECD.

IV. Timing aspects

EU Member States will have until 31 December 2019 to transpose the Directive into national laws and regulations which need to enter into force as from 1 January 2020 (apart from the measure on "reverse hybrid mismatches" which has to be implemented by 1 January 2022). This is a longer timeline than originally foreseen for the rules on hybrid mismatches in an EU context (i.e. ATAD required an implementation by 31 December 2018).

V. Conclusion

ATAD 2 replaces the rules on hybrid mismatches provided in the ATAD, postpones their implementation into the domestic tax laws of EU Member States by one year and extends the rules to third country mismatches. The extension to third countries has been criticized as damaging EU competitivity, however the EU States have decided to proceed nonetheless.

Given the extreme complexity of these rules including hybrid mismatches, reverse hybrid mismatches and so-called imported hybrid mismatches (which may occur somewhere in a group structure), the application of these anti-mismatch provisions will be a very intricate and time consuming exercise on the part of the taxpayers and the tax administrations.

One can hope that the Luxembourg legislator and tax authorities will not seek to go beyond the rules provided in ATAD 2, which are already very broad and complex.

Looking on the bright side of the Directive, it is positive that the guidance provided in the Directive clarifies many issues in relation to the scope and the application of these rules.

Although ATAD and ATAD 2 will only be implemented as from 2019 with a number of options for EU Member States when implementing the tax measures, taxpayers should already start assessing the potential impact of these changes on existing investment structures and closely monitor the legislative process around the implementation of the new rules.

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1) Economic and Financial Affairs Council.
2) Here, the directive sets a threshold of at least 50% of the voting rights, capital interests or rights to a share of profit for the rule to apply. It is interesting to note that in other situations, the ATAD rules apply when a shareholding relationship of at least 25% exists. Hence, the scope of the reverse hybrid rules is a bit more restrictive when it comes to the shareholding threshold.
3) Income that is taxable in two jurisdictions.