KPMG Meijburg & Co Tax Lawyers

EU Anti-Tax Avoidance Directive 2: hybrid mismatches with third countries

On February 21, 2017 the EU Member States reached agreement on a Directive that will amend the Anti-Tax Avoidance Directive (Council Directive (EU) 2016/1164 of July 12, 2016, 'ATAD 1'). The new Directive ('ATAD 2') amends Article 9 of ATAD 1, which covered certain hybrid mismatches between EU Member States. The scope of Article 9 is extended to include hybrid mismatches between EU Member States and third countries. In addition, ATAD 2 provides for rules consistent with the rules recommended by the OECD in the 2015 Final BEPS Report on Action 2. According to the Preamble to ATAD 2, the EU Member States should use the BEPS Action 2 Final Report as a source of illustration and interpretation to the extent the rules are consistent with the provisions of ATAD 2 and Union law.
ATAD 2 only covers mismatches between associated enterprises, between head offices and permanent establishments ('PEs'), PEs of the same entity or mismatches under a structured arrangement. The term 'associated' is defined in the Directive. Generally it covers direct and indirect interests of 25% or more, but for certain types of mismatches the percentage is increased to 50%. In addition, in certain situations the Directive deems that the parties involved are associated. ATAD 2 covers a number of (hybrid) mismatches, especially financial instrument mismatches; hybrid entity mismatches; reverse hybrid mismatches; permanent establishment mismatches; tax residency mismatches and imported mismatches.
Below we will provide an overview of the most important issues covered by ATAD 2.

Member States should implement Article 9 of ATAD 1 and the rules proposed by ATAD 2 by December 31, 2019 and apply the provisions as from January 1, 2020. However, Article 9A, which deals with so-called Reverse Hybrids will only have to be implemented by December 31, 2021 and be applied as from January 1, 2022. It is not clear whether Member States may or should apply Article 9 to Reverse Hybrids in the period between January 1, 2020 and January 1, 2022.

Financial instrument mismatches
A financial instrument is a debt, equity or derivative instrument. ATAD 2 targets the situation where a financial instrument leads to a mismatch. Mismatches that have already been targeted under the Parent Subsidiary Directive are not covered by ATAD 2. In the context of financial instrument mismatches, ATAD 2 defines a mismatch as a situation where a payment with respect to the instrument is deducted but does not lead to a corresponding inclusion at the level of the payee. Non-inclusion covers the situation where the payment qualifies for double tax relief. It also covers the situation where the payment is not included in income within a reasonable time, as defined by the Directive. The mismatch has to be the result of differences in the characterization of the instrument or the payments made under it. Differences in tax outcomes that are solely attributable to differences in the value of a payment or through the application of transfer pricing rules are not considered to be a mismatch. Based on the definitions in the Directive, interest-free loans that lead to deduction and non-inclusion should not be targeted by ATAD 2, provided the loan is not split into a debt part and an equity part at the level of the debtor. A Member State may temporarily exclude certain hybrid financial instruments that have been issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements from the scope of ATAD 2 until 31

December, 2022. The term financial instrument includes a hybrid transfer. A hybrid transfer means any arrangement to transfer a financial instrument where the underlying return on the transferred instrument is treated for tax purposes as derived simultaneously by more than one of the parties to the arrangement.
In the case of a financial instrument mismatch, the deduction should be denied in the state of which the payer is a resident (primary rule). Where this rule is not applied, the payment should be included in the Member State that is the payee jurisdiction. To the extent a hybrid transfer is designed to produce a withholding tax credit to more than one of the parties involved the Member State of the taxpayer should limit the benefit of the tax credit in proportion to the net taxable income regarding such payment.

Hybrid entity mismatches
An entity qualifies as a hybrid entity if according to one state the entity is non-transparent for tax purposes whereas according to another state the entity is transparent for tax purposes. A number of hybrid entity mismatches are covered by the Directive. This is the case if the use of a hybrid entity results either in a deduction without inclusion or in a double deduction. The mismatch may concern both payments made to the hybrid entity and payments made by the hybrid entity.

1. *Payment to hybrid entity, deduction without inclusion*

This may concern the payment made to an entity which is considered as non-transparent by the jurisdiction in which the persons with a controlling interest in the entity are resident, but is considered transparent by another state, as a result of which the payment is not included in the taxable income of the recipient. In such a case the deduction shall be denied in the state of which the payer is a resident (primary rule). If the deduction is not denied by the state of which the payer is a resident, the payment should be included in the income in the Member State that is the payee jurisdiction (secondary rule). However, a Member State may opt not to apply this secondary rule.
It should be noted that this type of hybrid mismatch may also qualify as a reverse hybrid mismatch in case the hybrid entity is incorporated or established in a Member State (see the next section of this memorandum). In that case, the specific reverse hybrid mismatch provision should be applied first. If the mismatch cannot be remedied as a result of that specific rule, the general rule just described should be applied.

2. *Payment by hybrid entity, deduction without inclusion*

This may concern the situation where the hybrid entity is present in a state that treats the entity as non-transparent. The entity makes a payment to a person that has an interest in the entity and this person is resident of a state that treats the entity as transparent and as a consequence disregards the payment made by the hybrid entity.
In such a situation, the deductibility of the payment should be denied at the level of the hybrid entity, i.e. the state that considers the entity to be non-transparent (primary rule).
If the primary rule is not applied, the payment should be included in income in the Member State that is the payee jurisdiction (secondary rule).

3. *Payment by hybrid entity, double deduction*

This may concern the situation where the hybrid entity is an intermediary company. The person that controls the hybrid entity ('investor') is resident of a state other than the state which considers the entity as a non-transparent resident entity. The investor jurisdiction considers the entity as transparent. As a result, payments made by the hybrid entity are deductible both in the investor state and in the state of which the entity is a resident.
In such a case, the state of which the investor is a resident, should deny the deduction of the payment (primary rule) if and to the extent the payment is deductible against income that is not dual-inclusion income (income that is recognized by only one of the states concerned). Where the deduction is not denied in the investor jurisdiction, the deduction should be denied in the Member State that is the payer jurisdiction.

Reverse hybrid mismatches

This concerns the situation where an entity that is incorporated or established in a Member State is treated by this Member State as transparent, whereas the jurisdiction of one or more associated non-resident entities that hold in aggregate a direct interest of 50% or more of the voting rights, capital interests or profit shares in the entity treats this entity as a taxable person.
In such a situation, the hybrid entity shall be regarded as a resident of that Member State as from January 1, 2022 and taxed on its income to the extent that this income is not otherwise taxed under the laws of the Member State or any other jurisdiction.

Mismatches resulting from the fact that an entity is a reverse hybrid entity may also fall under other provisions of the Directive. As a result, a payment made to a reverse hybrid entity which leads to deduction without inclusion, could also lead to the non-deductibility of the payment as from January 1, 2020. According to the Directive however, the reverse hybrid mismatch provision takes precedence over other provisions of the Directive. It is not clear whether Member States may or should apply Art. 9 to Reverse Hybrids in the period between January 1, 2020 and January 1, 2022. If a reverse hybrid entity mismatch is not covered by the special provision of Art. 9A, for example because the reverse hybrid entity has not been established under the law of a Member State or because it is not regulated by the company law of a Member State, then the mismatch resulting from the use of the reversed hybrid entity can still be targeted by other provisions of the Directive. This could for example lead to a denial of the deduction of the payment made to the reverse hybrid entity in the case of a deduction/no inclusion situation.
Collective investment vehicles are excluded from the scope of the provision on reversed hybrid mismatches.

Permanent establishment ('PE') mismatches

The Directive describes a number of PE mismatches and the remedies to be applied by the Member States.

1. *Disregarded PEs and relief from double taxation*

This concerns the situation where the Member State of which a taxpayer is a resident considers the taxpayer's activities in another state to constitute a PE, and grants double relief for the income attributable to this PE. The other state, however, does not recognize a PE.
In such a situation the Member State of which the taxpayer is a resident should refrain from granting double tax relief with respect to the income of the disregarded PE. However, this provision does not apply if a Member State is required to exempt the income under a double taxation treaty entered into by the Member State with a third country.

2. *PEs and mismatches in the allocation of income relating to deductible payments*

This may concern a 'triangular' situation where a deductible payment is made which, according to the state where the recipient of the payment is resident, is allocable to a PE of that taxpayer in another state. As a result, the state of the head office grants double tax relief. The PE state, however, does not tax the payment since it considers this payment not to be allocable to a PE within its jurisdiction.
In such a situation the state of which the payer is a resident should disallow the deduction (primary rule). If this state does not disallow the deduction, the Member State where the head office is located should include the income in the taxable base of the head office and not provide for double tax relief (secondary rule). However, a Member State may opt not to apply this secondary rule.

3. *PEs and mismatches relating to deemed payments between a head office and a PE resulting in a deduction without inclusion*

This may relate to so-called 'dealings' between a head office and a PE. A mismatch may for example occur where the state of the PE recognizes a deductible payment from the PE to the head office, whereas the state of the head office disregards the payment. In such a situation the state of the PE should not allow a deduction ('primary rule'). If this state does not disallow the deduction, the Member State where the head office is located should include the income in the taxable base of the head office and not provide for double tax relief (secondary rule). However, a Member State may opt not to apply this secondary rule.

4. *Payments by PE, double deduction*

This may cover the situation where the PE acts as an intermediary and heads a tax group in the state in which it is located and the payment made by the PE is tax deductible both in the state in which the PE is located and in the state where its head office is located. In such a case, the state where the head office is located should deny the deduction of the payment (primary rule) if and to the extent the payment is deductible against income that is not dual-inclusion income (income that is recognized by only one of the states concerned). Where the deduction is not denied in the head office jurisdiction, the deduction should be denied in the Member State where the PE is located.

Tax residency mismatches
This concerns the situation where a taxpayer is resident for tax purposes in two or more jurisdictions. As a result of this, payments, expenses or losses of this taxpayer are deductible from taxable income in more than one jurisdiction. To the extent this leads to duplicate deduction or set-off against income that is not dual-inclusion income (income that is recognized by only one of the states concerned), the Member State should deny the deduction or set-off. If the taxpayer is a dual resident of two Member States, the deductibility or set-off should be denied by the Member State of which the taxpayer is deemed not to be a resident according to the tax treaty between those Member States.

Imported mismatches
Similar to OECD BEPS Action 2, the Directive contains a provision against so-called imported hybrid mismatches. An imported hybrid mismatch shifts the effect of a hybrid mismatch into the jurisdiction of a member state through the use of a non-hybrid instrument within the framework of a structured arrangement. To illustrate the concept of an imported hybrid mismatch, we give the following example. A non-EU resident parent company grants a hybrid financial instrument to a non-EU resident subsidiary. The instrument is considered debt by the state of which the subsidiary is a resident and as equity by the state of which the parent is a resident. The hybrid instrument results in a deduction/no inclusion of the interest. The non-EU subsidiary on-lends the proceeds of the instrument to an EU resident group company. This loan is not a hybrid instrument. However, as a result of both instruments, the amount deducted by the EU resident group company is effectively not taxed.
In such a situation the EU Member State should deny the deduction of interest, except to the extent that the other states involved have made equivalent adjustments in respect of the hybrid mismatch.

Commentary by Meijburg & Co
The adoption of ATAD 2 is an important milestone in the European Commission's policy against aggressive tax planning. From a Netherlands perspective the most relevant provision concerns the reverse hybrid mismatch rule. The solutions provided for by ATAD 2 would typically impact current CV/BV situations.
The question is whether the EU Member States want to move further ahead by harmonizing corporate tax systems via the adoption of the CCTB and/or the CCCTB proposals that were launched by the European Commission in October 2016.

Meijburg & Co
February 2017