Analysis

ATAD II: the revised EU rules on hybrid mismatches

Speed read

The new anti-hybrids directive ('the Directive') is the latest step taken by the EU in response to the OECD's base erosion and profit shifting (BEPS) project. It seeks to implement the principles of Action 2 (hybrid mismatch arrangements), in particular with respect to mismatches between an EU member state and a third country. Agreed by the Council of the EU on 21 February 2017, EU member states will be required to implement most of the provisions of the Directive by 1 January 2020, although the rules governing reverse hybrids will not come into force until 1 January 2022.

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Background to the Directive

On 12 July 2016, the EU formally adopted Directive 2016/1164, known as the Anti-Tax Avoidance Directive (ATAD), which included measures to implement the recommendations of a number of BEPS action items, including Action 2 on hybrid mismatch arrangements. The hybrid mismatch provisions of the ATAD were limited in scope and only addressed mismatch arrangements arising between EU member states. It was therefore agreed that there should be a subsequent directive to amend the ATAD to address other areas of concern identified by Action 2, including introducing measures to address hybrid mismatch arrangements with third countries and expand the range of mismatches targeted. An initial draft was published on 25 October 2016, and the text of the Directive (ATAD II) was agreed by the Council of the EU on 21 February 2017. The European Parliament has proposed amendments to ATAD II (not discussed in this article), which were published on 8 March 2017 and were scheduled to be considered by the European Parliament's Economic and Monetary Affairs committee on 27 March 2017; a plenary vote of the European Parliament is currently scheduled for 26 April 2017, after which the Directive will be formally adopted by the Council of the EU.

Content

The ATAD II measures are noticeably more complex than the ATAD provisions on intra-EU hybrid mismatches. Unlike the OECD's Action 2 proposals, where counteraction depends upon the type of mismatch and whether the other jurisdiction has made any adjustments, the ATAD provisions simply provided that hybrid mismatches resulting in a double deduction (DD mismatches) should be addressed by allowing the deduction only in the source member state and that hybrid mismatches resulting in a deduction without a corresponding inclusion (D/NI mismatches) should be addressed by denying the deduction in the payer's member state.

Although the initial stimulus for ATAD II was targeting hybrid mismatches between EU member states and third countries, the Directive also introduces measures to address types of hybrid mismatch that were not within scope of the ATAD rules – in particular, hybrid mismatches involving permanent establishments (PEs), hybrid transfers, imported mismatches, dual-resident mismatches and reverse hybrids – in an attempt to make the EU's hybrids rules 'consistent with and no less effective than' the Action 2 recommendations. This is done by significant alterations to the definition of 'hybrid mismatch' and the replacement of ATAD article 9 with three new articles tackling hybrid mismatches, reverse hybrid mismatches and tax residency mismatches.

Definition of hybrid mismatch

Under the ATAD, a hybrid mismatch was limited to DD or D/NI mismatches arising in intra-EU situations due to differences in the legal characterisation of a financial instrument or entity. Under ATAD II, this is expanded to include:

- D/NI mismatches arising intra-EU or with third countries as a result of:
  - differences in the characterisation of a financial instrument or a payment made thereunder (where such payment is not included within a reasonable period (broadly a tax period commencing within 12 months of the end of the payer's tax period));
  - differences in the allocation of payments made to a hybrid entity between the jurisdiction where it is established and the jurisdiction of its interest holders;
  - differences in the allocation of payments between a head office and PE or between two or more PEs of the same entity under the laws of the jurisdictions where the entity operates;
  - payment to a disregarded PE;
  - payment by a hybrid entity being disregarded under the laws of the payee jurisdiction; and
  - deemed payments between a head office and PE or between two or more PEs being disregarded under the laws of the payee jurisdiction; and
- all DD mismatches,

provided that the mismatch arises between associated enterprises, between a taxpayer and an associated enterprise, between a head office and a PE, between two or more PEs of the same entity, or under a structured arrangement (although there is a limited exception for certain arrangements entered into by financial traders).

New article 9: hybrid mismatches

ATAD II provides the following:

- For DD mismatches, the primary response is to deny the deduction in the investor jurisdiction and, if this does not occur (perhaps because the investor jurisdiction is not a member state), the secondary response is to deny the deduction in the payer jurisdiction (although any deduction will remain eligible to be set off against dual-inclusion income in a current or subsequent period);
- For D/NI mismatches, the primary response is to deny the deduction in the payer jurisdiction and, if this does not occur, the secondary response is to include the amount of the relevant payment as income in the payee jurisdiction.
- A member state shall deny a deduction to the extent that the relevant payment funds deductible expenditure giving rise to a hybrid mismatch through a transaction (or series thereof) between associated enterprises or entered into as part of a structured arrangement, unless one of the jurisdictions involved in the transaction has made an equivalent adjustment.
- Where a hybrid mismatch involves disregarded PE income not subject to tax in the member state where the taxpayer is resident, that member state shall require the taxpayer to include the income that would otherwise be attributed to the disregarded PE, unless the member state is required to exempt that income pursuant to a double tax treaty entered into with a third country. (Note that it is not clear how this provision applies, as it requires a hybrid mismatch rather than a simple failure to tax income in either jurisdiction.)
- Where a hybrid transfer is designed to produce relief from withholding tax on a payment derived from a transferred financial instrument for multiple persons, the member state of the taxpayer shall limit the benefit of such relief in proportion to the net taxable income regarding such payment.

This is to be applied from 1 January 2020, although certain exclusions apply for hybrid regulatory capital until 31 December 2022.

New article 9a: reverse hybrid mismatches

ATAD II provides that, where a member state would usually treat an entity as transparent, it shall be regarded as a resident of that state and taxed accordingly where non-resident entities holding 50% or more of the voting rights, capital interests or rights to a share of profits are located in jurisdictions regarding that entity as a taxable person. There is an exception for collective investment vehicles (being investment funds or vehicles that are widely held, hold a diversified portfolio of securities and are subject to investor protection regulation in their country of establishment).

This is to be applied from 1 January 2022.

New article 9b: tax residency mismatches

ATAD II provides that, where dual-residence results in a DD mismatch, the member state of residence shall deny the deduction to the extent that the other jurisdiction allows the deduction to be set against non-dual-inclusion income. Where both residence jurisdictions are member states, the deduction shall be denied where the taxpayer is not deemed to be resident according to the tax treaty between those two member states.

This is to be applied from 1 January 2020.

Areas of uncertainty

Although the hybrids rules introduced by ATAD II are significantly more comprehensive than those under the ATAD, and bear greater resemblance to the OECD proposals, there are still a number of areas of uncertainty:

Timeframe for implementation

Although ATAD II 'replaces' the hybrids provisions of ATAD, they are not required to be implemented until 1 January 2020 (or later in the case of the reverse hybrids provisions), although they may be implemented earlier. In the meantime, it is unclear whether member states remain obliged to implement the more limited ATAD rules by 1 January 2019 (i.e. whether ATAD II replaces ATAD article 9 with immediate effect or with effect from the date by which it must be implemented).

Although there is an extended timeframe to implement the reverse hybrids rules (unless jurisdictions implement these early), taxpayers likely to be affected by them may also be caught by other parts of ATAD II, so will need to be aware that the method of counteraction may change over time.

Approach

The Directive lays down principle based rules and leaves the details of implementation to member states so they can tailor the key components of the rules to fit their domestic tax systems. This could result in inconsistent implementation between member states (possibly creating additional mismatches) and raises the question of whether member states that have already taken steps to implement the OECD's Action 2 recommendations will be considered compliant with the Directive.

There is a risk of double taxation where deductions are denied in circumstances where there is not a current year inclusion elsewhere but one may arise in future

Scope

The Directive applies to all taxpayers subject to corporate tax in a member state. This fails to take account of the possibility that taxpaying entities may be subject to income tax instead, meaning it is possible for mismatches to arise between corporate entities that would not be caught by the rules.

Uneven implementation

The burden of adjustments to tackle hybrid mismatches will fall on early adopters of these rules, since non-simultaneous implementation is likely to increase reliance on secondary adjustments/imported mismatch rules. This could distort short-term transaction/business structuring within the EU.

Risk of double taxation

There is a risk of double taxation where deductions are denied in circumstances where there is not a current year inclusion elsewhere but one may arise in future. Although the preamble indicates that timing differences should not generally be treated as giving rise to mismatches in tax outcomes, most of the definitions of hybrid mismatch do not reflect this. Those that do are limited in time and difficult to apply if future inclusion is uncertain (and there is no provision for adjustment if there is an unforeseen subsequent inclusion).

There is no provision for action taken to counteract an imported mismatch to be reversed if it is subsequently countered by one of the countries party to the original mismatch.

It is not clear whether counterparty jurisdictions will give credit for double tax suffered due to the application of anti-hybrids rules.

Interaction with UK implementation of BEPS Action 2

The UK has been an early adopter of the BEPS project recommendations, and has arguably put itself at a competitive disadvantage (and increased reliance on imported mismatch rules) by introducing domestic anti-hybrids legislation with effect from 1 January 2017. Although ATAD II aims to level the playing field between EU jurisdictions by obliging them to implement the OECD's Action 2 recommendations, it is unclear whether this will actually be the result.

Unlike the ATAD II provisions, which run to only a few pages, the UK's domestic anti-hybrids legislation is long and detailed; although the mismatches targeted and the general approach to counteraction are broadly the same under both sets of rules, the detail of the UK rules exceeds OECD best practice recommendations, so the UK is not expected to take action in response to ATAD II. In any event, as the deadline for member states to implement ATAD II falls after the expected date of the UK's departure from the EU, the UK is unlikely to be required to comply with it in practice.

The UK's intended 'Brexit' does not, however, prevent differences between the UK domestic regime and ATAD II being relevant for EU taxpayers engaged in cross-border transactions involving the UK; as a third country, the UK's approach to counteracting hybrid mismatches would influence the counteraction requirements in EU member states affected by such transactions.

Final thoughts

ATAD II clearly represents a significant advance in terms of EU implementation of the OECD's recommendations to tackle hybrid mismatches. However, it also presents a number of challenges, including how it will interact with domestic implementation of the OECD's recommendations (both within and outside the EU), the risk of double taxation, and how to restructure arrangements that may be caught by the new rules. Although we anticipate that significant amendments to the text of the Directive agreed by the Council are unlikely, the European Parliament's proposals should be monitored as the Directive is finalised. ■

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- Hybrids: the UK and OECD proposals (Tom Scott, 29.10.15)
- Hybrids: making sense of the draft guidance (James Ross, 19.1.17)
- 30 questions on BEPS (Jill Gatehouse & Susie Brain, 29.10.15)
- Special report: BEPS and business (14.3.17)