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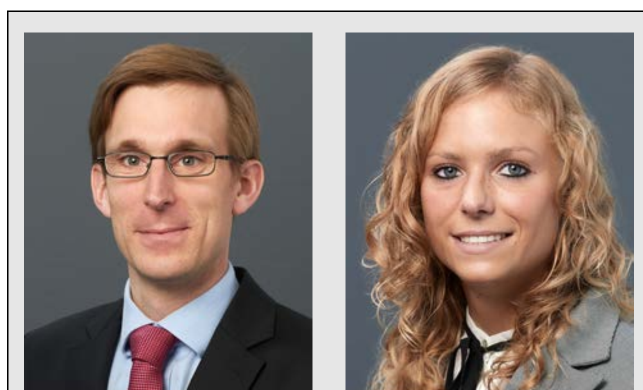
Hybrid Mismatches: Game Over?

by Charles-Albert Helleputte and Séverine Bouvy



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In this article, the authors discuss hybrid mismatches and how the changing landscape in the EU may affect cross-border tax planning.

Hybrid mismatches have always been part of the cross-border tax planning landscape. Because countries are reluctant to give up their tax sovereignty — even in Europe — there are as many taxation systems as there are countries; mismatches are almost inherent in the way tax law is construed.[1] At some point, countries promoted those differences as incentives to attract business or investment.

With a changing landscape gearing toward more transparency and ever-increased needs to fund public budgets, common, genuine tax arrangements are under scrutiny. The EU is a front-runner in its implementation of the base erosion and profit-shifting framework intended to address what is considered unfair behavior by companies.

Common Hybrids

There are several common hybrid arrangements:

- Hybrid entity mismatch, which occurs when an entity is treated as transparent for tax purposes by one jurisdiction and as nontransparent by another. This would lead to a double deduction of the same payment, expenses, or losses or to a deduction of a payment without a corresponding inclusion of that payment.
- Hybrid financial instrument mismatch, which occurs when the tax treatment of a financial instrument differs between two jurisdictions, leading to a deduction of a payment from the payer's taxable base without an inclusion of that payment in the recipient's taxable base.
- Hybrid permanent establishment mismatch, in which one jurisdiction treats the business activities in a jurisdiction as being carried out through a PE while another jurisdiction does not. This leads to nontaxation without inclusion, double deductions, or a deduction without inclusion.
- Hybrid transfer, which is an arrangement to transfer a financial instrument when the laws of two jurisdictions differ on whether the transferor or the transferee possesses the ownership of the payments on the underlying asset. This leads to a deduction without inclusion.

[1] Stephen Edge, "Base Erosion and Profit Shifting: A Roadmap for Reform — Tax Arbitrage With Hybrid Instruments," *Bull. Int'l Tax'n* 318 (June/July 2014). *See also* Jürgen Lüdicke, "Tax Arbitrage With Hybrid Entities: Challenges and Responses," *Bull. Int'l Tax'n* 309 (June/July 2014).

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- Imported mismatch, which arises when arrangements shift the effect of a hybrid mismatch between parties that are not EU-based to the jurisdiction of a member state via a non-hybrid instrument. A mismatch is imported into a member state if a deductible payment under a non-hybrid instrument is used to fund expenditures under a structured arrangement involving a hybrid mismatch between non-EU countries (implying a flow of revenue out of the EU eventually not being taxed), leading to a deduction in a member state accompanied by a double deduction or a deduction without inclusion between third countries.
- Dual resident mismatch, in which a dual resident taxpayer makes a payment that is deductible under the laws of both resident jurisdictions, which can lead to a double deduction.

The Rise of a New Era

The use of hybrid arrangements started to come under scrutiny in the aftermath of the financial crisis, when member states began to pay close attention to the protection of their national budgets. Scandals such as LuxLeaks and the Panama Papers drew public attention to hybrids and the perception that they can result in a substantial erosion of the taxable basis of corporate taxpayers in the EU.[2] That situation resulted in growing pressure from various actors at different levels against the use of hybrid mechanisms.

The OECD addressed hybrid arrangements at an international level in March 2012 in "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues." The OECD began the BEPS project in July 2013 and issued its final reports in October 2015. Its goal is to fight aggressive tax planning techniques used to exploit tax system loopholes and mismatches between national rules to artificially shift profits to low- or no-tax locations with little or no economic activity and reduce tax liabilities. The BEPS project includes 15 action points, each of which provides measures to tackle those kinds of structures. The final action 2 report targets hybrid mismatch arrangements and requires coordination in implementation.[3]

Some countries unilaterally adopted national measures to fight the use of hybrid instruments in light of then-upcoming OECD developments, or even as a way to be front-runners.[4] Spain's 2015 tax law changes linked the deductibility of expenses arising from hybrid instruments to the tax treatment of the company receiving the income.[5] The U.K. introduced national measures to fight hybrid mismatches and tax arbitrages. It denied deductions that were greater than what would ordinarily have occurred in situations in which no tax (or less tax than normally would have been due) was due overseas.[6]

The parent-subsidiary directive (PSD, 2011/96/EU) allowed taxpayers to benefit from a deduction and noninclusion of a payment. In 2014 the European Union decided to tackle the use of hybrid instruments to exploit loopholes, and therefore amended the PSD (Council Directive 2014/86/EU) to say the tax exemption should not be granted if a qualifying payment is deductible in the source member state — a change that clearly targeted profit-participating loan-type arrangements.

In 2016 the EU responded to the BEPS project by adopting a coordinated EU approach against corporate tax abuse in the form of an anti-tax-avoidance directive (ATAD, 2016/1164/EU).[7] The

[2] David Fernley and Michael Moroney, "EU Anti-Tax Avoidance Package: Impacts on Financial Institutions," 18 *Derivatives & Fin. Instruments* (Oct. 13, 2016); and Martijn Nouwen, "The Gathering Momentum of International and Supranational Action against Aggressive Tax Planning and Harmful Tax Competition: The State of Play of Recent Work of the OECD and European Union," 53 *Eur. Tax'n* (Sept. 4, 2013).

[3] Jason Osborn, Brian Kittle, and Ken Klein, "Are the Final BEPS Reports on Actions 8-10 Effective Now?" *Tax Notes Int'l*, Aug. 22, 2016, p. 709.

[4] For example, Denmark, France, Spain, and Sweden. For further details about those domestic regimes, see, respectively, Jakob Bundgaard, "Coordination Rules as a Weapon in the War against Cross-Border Tax Arbitrage — The Case of Hybrid Entities and Hybrid Financial Instruments," *Bull. Int'l Tax'n* 200-204 (Apr./May 2013); and Anna Hanko Farago, "Reaction to the Final OECD BEPS Package," *Int'l Transfer Pricing J.* 266 (May/June 2016).

[5] Enric Girona, "Spain. New Anti-Hybrid and Anti-Abuse Tax Measures," 17 *Derivatives & Fin. Instruments* (Sept. 18, 2015).

[6] Aloys Rigaut, "Anti-Tax Avoidance Directive (2016/1164): New EU Policy Horizons," *Eur. Tax'n* 504-505 (Nov. 2016); and Edge, *supra* note 1.

[7] Fernley and Moroney, *supra* note 2.

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directive lays down rules against taxpayer schemes to take advantage of disparities in national tax systems to reduce their tax liability.

ATAD article 9 addresses hybrid mismatch arrangements in the EU. That measure is meant to neutralize tax effects — such as double deductions or deductions in one member state without inclusion in the tax base of the other — arising from jurisdictional differences in the legal characterization of financial instruments or entities.

Taxpayers also use hybrid mismatch arrangements with countries outside the EU (one immediately thinks of U.S. check-the-box arrangements and convertible preferred equity certificates). So just before adoption of the ATAD, the Economic and Financial Affairs Council asked the European Commission to propose rules by October 2016 on hybrid mismatches involving non-EU countries that at a minimum, contained rules consistent with, and no less effective than, those recommended by the BEPS action 2 report.

The commission issued its proposal on October 15, 2016, targeting several types of hybrid mismatches taking place both inside and outside the EU, and in February the EU Council endorsed the proposal. If adopted, the proposal would amend the ATAD to require EU member states to fight mismatches by denying deductions or including revenues in a taxpayer's taxable basis.

The commission's proposal targets hybrid mismatches arising between a taxpayer and an associated enterprise or a structured arrangement between parties in different jurisdictions. The ATAD already covers hybrid entity and hybrid financial instrument mismatches, the most common forms of hybrid mismatch arrangements in the EU, and the proposal tackles those arrangements when non-EU countries are involved. It also extends the directive to other types of mismatches, such as hybrid PE mismatches, hybrid transfers, imported mismatches, and dual-resident mismatches.

Member states must implement the proposal by December 31, 2019, for an effective date of January 1, 2020. However, member states may temporarily carve out specific financial instruments or situations from the scope of the proposal. That carveout applies primarily to hybrid regulatory capital instruments and activities of financial traders, and would apply only until December 31, 2021.

In hybrid mismatches, the proposal requires the relevant member state to deny the deduction of the problematic payment or to include it in a taxpayer's basis. It also requires varying action based on the result of a mismatch, the type of mismatch, and whether a mismatch takes place between EU or non-EU jurisdictions.

Double Deduction

If a hybrid mismatch results from the use of a hybrid entity, hybrid financial instrument, or intra-EU hybrid transfer, the member state where the payment is sourced, the expenses are incurred, or the losses are suffered shall deny the deduction. If a non-EU country is involved, the member state shall deny the deduction of the payment, expense, or loss, unless the non-EU country has already done so.

For an imported mismatch leading to a double deduction in a non-EU country, the taxpayer's member state shall deny the deduction unless one of the countries involved has already done so.

In a dual-residency mismatch leading to a deduction in both a member state and a non-EU country, the member state should deny the deduction of payments, expenses, or losses, but only to the extent that those items are offset by income that is not included in the non-EU country.

Deduction Without Inclusion

If the use of a hybrid entity, hybrid financial instrument, or hybrid transfer leads to a deduction without inclusion, the payer's member state shall deny the deduction. However, if the payer is located in a third country, the member state must include the payment in the payee's taxable basis unless the deduction has already been denied by the non-EU country or the payment has already been included in the payer's taxable basis.

If an imported mismatch leads to a deduction without inclusion in third countries, the taxpayer's member state shall deny the deduction of the payment made to the associated enterprise located in a non-EU country unless one of the non-EU countries involved has already denied the deduction.

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Double Relief for Tax Withheld at Source

If a hybrid mismatch results in relief for tax withheld at source on a payment derived from a transferred financial instrument to more than one of the parties involved, the taxpayer's member state must limit that relief in proportion to the net taxable income of that payment.

Nontaxation Without Inclusion

For hybrid mismatches involving a PE that result in nontaxation without inclusion, the member state where the taxpayer is tax resident shall require the taxpayer to include in its taxable base the income attributed to the PE, even if the PE is in a non-EU country.

Timing Differences

The proposal states that timing differences resulting from the use by jurisdictions with different tax accounting periods and different rules for recognizing when items of income or expenditure have been earned or incurred should not be treated as giving rise to tax mismatches. However, if timing differences occur, the payer should ensure that the payment is recognized in the payee's jurisdiction within a reasonable period, or the ATAD applies.

Effect on Tax Planning Structures

The proposal seems like "game over" for common hybrid mismatch arrangements, which would likely result in increased tax liability for some taxpayers. Preferred or convertible preferred equity certificates, mandatorily redeemable preferred shares, and debt instruments stapled with an equity instrument, the redemption of convertible debt instruments, and more classic U.S. check-the-box arrangements would be affected.

Indeed, an EU payer under a hybrid instrument that allows a deduction in the payer's jurisdiction (for example, preferred equity certificates or mandatorily redeemable preferred shares) will be denied that deduction by the member state where it is located if the payment is not included in the taxable basis by the payee's jurisdiction (although not if the sole inclusion is deferred for a short time).

An EU parent receiving from an EU subsidiary revenue earned from a debt instrument stapled with an equity instrument might also have reason for concern. If the interest received under the debt instrument is exempt in the recipient state (because it is regarded as a dividend; for example, in Luxembourg) and is deductible in the subsidiary state, the member state of the receiving entity might have to include in the parent's taxable basis any income that is deductible in the subsidiary member state.

For an EU issuer that would redeem a convertible debt instrument at fair market value and benefit from a deduction in its jurisdiction, the issuer member state should deny the deduction if the revenue is not included at the parent level.

Repos might also be at stake. Structures using those kinds of features would typically rely on a payment connected with the underlying return on the transferred instrument and regarded as a deductible expense by one jurisdiction and as a tax-exempt return on the underlying asset by another jurisdiction. That leads to a deduction without inclusion, so the deduction might be denied.

Securities lending transactions could also come under scrutiny because they might lead to taxpayers resident in different jurisdictions claiming withholding tax credits on the same income. The ATAD addresses that by limiting the amount of the credit in proportion to the taxpayer's net income under the arrangement.

The proposal also makes clear that the directive targets hybrid mismatches arising from jurisdictional differences in the legal characterization of an entity or a financial instrument, which affects the qualification of an entity or financial instrument for tax law purposes. Therefore, tax arrangements using U.S. check-the-box rules to take advantage of jurisdictional differences in the classification of an entity as transparent (or not) and leading to a deduction in one jurisdiction without inclusion in the other might be affected as well. In situations involving both an EU and non-EU country, the member state of the payer or the payee might deny the deduction or include the payment in the taxpayer's taxable base, as the case may be.

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Despite those possible effects, the proposal seems to leave some room for tax planning or incentives. Because its objective is "to improve the resilience of the internal market as a whole against hybrid mismatch arrangements," it does not address situations in which little or no tax has been paid as a result of a low tax rate or a favorable tax system. When the proposal requires a member state to include the income in the taxable basis, it does not require that the income be effectively taxed. For example, a member state might include revenue in the taxable basis and then grant an exemption or tax the revenue at a reduced rate.

Many Questions Left

There is still work to do before the proposal can be adopted, and many questions remain.

Interaction With Other Instruments

The interaction between the PSD and the amended ATAD isn't addressed by either document.[8] The action 2 report provides:

> The defensive rule, which imposes the same type of restriction in the payer jurisdiction, will only apply in the event that the effect of mismatch is not neutralized in the parent jurisdiction and is limited to those cases where the parties to the mismatch are in the same control group or the taxpayer is party to a structured arrangement.

PSD provisions, particularly the antiabuse clauses, should likely apply first because the PSD requires the action of the parent's member state. If not, the amended ATAD should apply because it requires action from the subsidiary's member state. That would seem reasonable, given the PSD's status as a *lex specialis*, but would likely depend on how member states implement EU provisions in their domestic laws.

Should PSD provisions apply first, companies might face a different treatment of dividends depending on the parent's level of participation and whether a non-EU country is involved. Indeed, regardless of the special rules when hybrid entities are involved,[9] the ATAD requires a higher participation or control threshold than the 10 percent required by the PSD.

With hybrid financial instruments, a dividend deducted in one country and exempted in the other leads to a deduction without inclusion. Under the proposal, the subsidiary's member state should deny the deduction but under the OECD action 2 report, the parent's member state should deny the exemption. The PSD adopted the OECD's solution, and the lack of coherence is paving the way for difficult situations.

Infringing Non-EU Sovereignty?

If the payer is in a non-EU country that allows deduction of the payment and the payee is in a member state that does not include that payment in the payee's taxable basis, the proposal requires the member state to include the payment in the basis unless the non-EU country denies the deduction. In doing that, the proposal tries to tax revenue that has been generated elsewhere and deliberately exempted by those countries. While it produces the expected result — that is, it generates revenue — that rule might be perceived as an infringement of non-EU countries' sovereignty.[10]

Conclusion

By stopping tax avoidance mismatches, the proposal will end tax planning techniques that have been in place for decades — yet another sign of how increased public awareness and the need to fund public deficits affect the way companies do business. Navigating those changes might prove complex and will require agility and anticipation by taxpayers. The years of implementation — 2020 or even 2022 — will arrive quickly. Now is the time for taxpayers to adapt existing tax strategies and rethink or restructure the way they operate. ■

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[8] The same problem arises between the PSD and OECD action 2 report. *See* Christian Kahlenberg and Agnieszka Kopec, "Hybrid Mismatch Arrangements — A Myth or a Problem That Still Exists?" *World Tax J.* 76-77 (Feb. 2016).

[9] In this case, other percentages of ownership apply in both regimes.

[10] See, for example, the related theory developed by Kahlenberg and Kopec, *supra* note 8.

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