HYBRID MISMATCH RULES IN LUXEMBOURG

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On 19 December 2019, the Luxembourg legislator passed the law implementing EU Directive 2017/952 of 29 May 2017 (the "Anti-Tax Avoidance Directive 2" or "ATAD 2") which provides for a comprehensive framework to tackle hybrid mismatch arrangements in a mere EU context and in transactions involving third States. This is the first of two articles that analyse the scope and limits of the new hybrid mismatch rules and the mechanisms for neutralising hybrid mismatch outcomes.

I. INTRODUCTION

Hybrid mismatches typically result from a different tax treatment of an entity, a permanent establishment ("PE") or a financial instrument under the laws of two or more jurisdictions and may give rise to deduction without inclusion or double deduction outcomes.

The new hybrid mismatch rules target a variety of different situations including direct hybrid mismatches between associated enterprises, structured arrangements between third parties, imported hybrid mismatches and tax residency mismatches. Most of the hybrid mismatch rules are included in a new version of Article 168*ter* of the Luxembourg Income Tax Law[2] ("LITL") which entered into force on 1 January 2020. In addition, Article 168*quater* of the LITL provides for a reverse hybrid mismatch rule that will apply as from tax year 2022.

While the primary objective of the hybrid mismatch rules is the elimination of double non-taxation, tax adjustments under the hybrid mismatch rules should likewise not result in economic double taxation. This is ensured through a number of carve-outs and limitations that discharge the application of the hybrid mismatch rules.

ATAD 2 follows the recommendations of the OECD in regard to Base Erosion and Profit Shifting ("BEPS") Action 2 that aim at neutralising the effects of hybrid mismatch arrangements through the application of linking rules that align the tax treatment in two or more jurisdictions. ATAD 2 explicitly states that the explanations and examples in the Final Report on Action 2 may be a source of interpretation to the extent this guidance is consistent with the provisions of the Directive.[3]

II. SCOPE OF THE HYBRID MISMATCH RULES

A. *Opening comments*

Article 168*ter* of the LITL addresses four categories of hybrid mismatches:

- hybrid mismatches that result from payments under a financial instrument, including hybrid transfers;
- hybrid mismatches that are a consequence of differences in the allocation of payments made to a hybrid entity or PE, including as a result of a payment to a disregarded PE;
- 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; and
- double deduction outcomes resulting from payments made by a hybrid entity or PE.

However, a mismatch outcome shall not be treated as a hybrid mismatch within the meaning of Article 168*ter* of the LITL unless it arises:

- between associated enterprises;
- between a taxpayer and an associated enterprise;
- between the head office and PE;
- between two or more PEs of the same entity; or under a structured arrangement (in this case, even unrelated

1. The author may be contacted at: oliver.hoor@atoz.lu. The author wishes to thank Samantha Schmitz (Chief Knowledge Officer) for her assistance.
2. The new version of Article 168*ter* of the LITL replaced the previous hybrid mismatch rules which have been introduced as part of the 2019 tax reform implementing EU Directive 2016/1164 of 28 January 2016 (the "Anti-Tax Avoidance Directive" or "ATAD").
3. See recital 28 of ATAD 2.

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parties may come within the scope of the hybrid mismatch rules).[4]

Article 168*ter* (3) No. 3 of the LITL further targets so-called imported hybrid mismatches that shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of EU Member States through the use of a non-hybrid instrument.

Finally, Article 168*ter* (4) of the LITL provides for rules that aim at neutralising double deduction outcomes in case of tax residence mismatches (i.e. when an entity is resident for tax purposes in two or more jurisdictions).

B. Personal scope of application

The hybrid mismatch rules apply to all Luxembourg corporate taxpayers, i.e. entities within the meaning of Article 159 of the LITL (Luxembourg companies, cooperatives, etc.) and Luxembourg permanent establishments ("PE") of non-resident corporate entities[5].[6]

C. Mismatch outcomes

Article 168*ter* of the LITL applies in case of mismatch outcomes which comprise deductions without inclusion and double deductions[7].

Deduction without inclusion (D/NI)

Deductions without inclusion are defined as the deduction of a payment (or deemed payment between the head office and PE or between two or more PEs) in any jurisdiction in which that payment (or deemed payment) is treated as made (payer jurisdiction) without a corresponding inclusion for tax purposes of that payment (or deemed payment) in the payee jurisdiction. In this regard, the payee jurisdiction is any jurisdiction where that payment or deemed payment is received or treated as being received under the laws of any other jurisdiction[8].

If the payment is brought into account as ordinary income in at least one jurisdiction, there will be no mismatch for the rule to apply[9]. In more complex situations (involving several entities), the concept of inclusion may require an economic interpretation. For example, in case of US investors that treat companies in a chain of companies as transparent for US tax purposes (i.e. check-the-box election), the inclusion of the income of the operational subsidiary at the level of the US investors should suffice to discharge the application of the hybrid mismatch rules as there is no mismatch outcome from an economic perspective.[10]

The payment is deemed to be included in the taxable income if it is subject to tax at the taxpayer's standard rate regardless of the timing of the inclusion (unless a specific provision requires an inclusion within a certain time frame[11]). This should be the case if the payment does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular types of payments.

However, inclusion does not require effective taxation. Thus, if the payee has tax losses that offset the income related to the payment, the latter will be considered as included for the purposes of the hybrid mismatch rules[12]. Moreover, the reduction of the tax by a credit granted by the payee jurisdiction for withholding tax or other taxes imposed by the source jurisdiction on the payment does not jeopardize the inclusion of the payment[13].

Double deduction (DD)

Double deductions are defined as a deduction of the same payment, expenses or losses in the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered (payer jurisdiction) and in another jurisdiction (investor jurisdiction). In the case of a payment by a hybrid entity or a PE, the payer jurisdiction is the jurisdiction where the hybrid entity or PE is established or situated[14].

However, as no mismatch outcome arises when a (double) deduction is offset against dual inclusion income (that is income that is included in the tax base in two jurisdictions), the hybrid mismatch rules only apply in case of double deductions that are offset against non-dual inclusion income.

D. Related party test

1) Definition of associated enterprises

The scope of hybrid mismatch arrangements is generally limited to transactions between associated enterprises.

4. Article 168*ter* (2) of the LITL.
5. Article 160 (1) of the LITL.
6. Article 168*ter* (1) No. 1 of the LITL.
7. Article 168*ter* (1) No. 3 of the LITL.
8. Article 168*ter* (1) No. 6 of the LITL.
9. See, for example, Final Report on BEPS Action 2, p. 41, No. 89 and p. 57, No.149.
10. See pages 19 and 20 of the Opinion of the Luxembourg State Council of 10 December 2019.
11. See page 16 of the Opinion of the Luxembourg State Council of 10 December 2019; as a general rule, mere timing differences should not trigger the application of the hybrid mismatch rules.
12. See page 16 of the Opinion of the Luxembourg State Council of 10 December 2019.
13. See Final Report on BEPS Action 2, p. 28, No. 32.
14. Article 168*ter* (1) No. 5 of the LITL.

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Therefore, the related party test is a cornerstone of the hybrid mismatch rules.

According to Article 168*ter* (1) No. 18 of the LITL, the term "associated enterprise" is defined as follows:

- an entity in which the taxpayer directly or indirectly holds a participation of at least 50% in terms of voting rights or capital ownership, or is entitled to receive at least 50% of an entity's profit;
- an individual or an entity that directly or indirectly holds a participation in the Luxembourg corporate taxpayer of at least 50% in terms of voting rights or capital ownership, or is entitled to receive at least 50% of the taxpayer's profits;
- an entity that is part of the same consolidated group for financial accounting purposes (i.e. a group consisting of all entities which are fully included in consolidated financial Statements drawn up in accordance with the International Financial Reporting Standards [IFRS] or the national financial reporting system of an EU Member State);
- an entity in which the taxpayer has a significant influence in the management or an entity that has a significant influence in the management of the taxpayer.

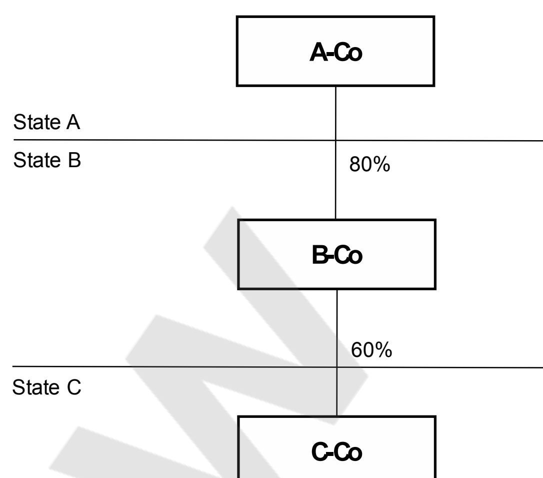
Where an individual or an entity directly or indirectly holds a participation of at least 50% in terms of voting rights or capital ownership in the taxpayer and one or several other entities, all these entities, including the taxpayer, are considered as associated enterprises within the meaning of Article 168*ter* of the LITL[15].

With regard to hybrid mismatches involving hybrid financial instruments within the meaning of Article 168*ter* (1) No. 2 a) of the LITL, the threshold requirement of 50% is reduced to 25%[16].

When determining the percentage of an indirect participation, the shareholding percentages through the chain must be multiplied by each other.

Example: Indirect Subsidiary

A company resident in State A ("A-Co") owns an 80% participation in a company resident in State B ("B-Co") that owns a 60% participation in a company resident in State C ("C-Co"). Here, A-Co indirectly owns a participation of 48% (= 80% * 60%) in C-Co.



2) Aggregation of interests

In certain circumstances, the shareholding percentages of otherwise unrelated parties should be aggregated for the purposes of the related party test. More precisely, a person who acts together with another person in respect of voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other person[17].

The purpose of the "acting together" concept is to prevent taxpayers from avoiding the related party test being met by transferring their voting interest or equity interests to another person who continues to act under their direction in relation to those interests.

The other situation targeted by the acting together concept is where a taxpayer or a group of taxpayers who individually hold minority stakes in an entity, enter into arrangements that would allow them to act together (or under the direction of a single controlling mind) to enter into a hybrid mismatch arrangement with respect to one of them[18].

According to the Final Report on BEPS Action 12, two persons will be treated as acting together in respect of ownership or control of any voting rights or equity interests if:

a) they are members of the same family, including a person's spouse, the relatives of that person and their spouses. A relative includes grandparents, parents, children, grandchildren and brothers and sisters (including adopted persons and step-siblings), but it

15. Article 168*ter* (1) No. 18 of the LITL.
16. Article 168*ter* (1) No. 18 of the LITL.
17. Article 168*ter* (1) No. 18 of the LITL.
18. See Final Report on BEPS Action 2, page 117, No. 369.

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would not include indirect or non-lineal descendants, such as a person's nephew or niece;

b) one person regularly acts in accordance with the wishes of the other person. This will be the case when the person is legally bound to act in accordance with another's instructions or if it can be established that one person is expected, or typically acts, in accordance with another's instructions;

c) they have entered into an arrangement that has material impact on the value or control of any such rights or interests.

This test covers both arrangements concerning the exercise of voting interests (such as the right to participate in any decision-making) and regarding beneficial entitlements (such as entitlement to profits or eligibility to participate in distributions) or arrangements concerning the ownership of those rights (such as agreements or options to sell such rights).

This test is intended to capture arrangements that are entered into with other investors and does not cover arrangements that are simply part of the terms of the equity or voting interest or operate solely between the holder and the issuer.

Moreover, the arrangement regarding the ownership or control of voting rights or interests must have a material impact on the value of those rights or interests. This materiality threshold prevents investors from having their equity or voting interests treated as part of a common holding arrangements, simply because investors are a party to a commercially standard shareholder or investor agreement that does not have a material impact on the ability of a holder to exercise ownership or control over the equity or voting interest; or

d) the ownership or control of any such rights or interests are managed by the same person or group of persons. This test may pick up a number of investors whose investments were managed under a common investment mandate or partners in an investment partnership[19].

3) Investments funds

Luxembourg is a global hub for the structuring of Alternative Investments in and through Europe. Therefore, the question as to how the concept of acting together applies in a fund context is of crucial importance. In this regard, Article 168*ter* of the LITL provides for a *de minimis* rule[20].

Investment funds have been defined as "any collective investment undertakings which raise capital from a number of investors, with a view to investing this capital in accordance with a defined investment policy for the benefit of those investors." It follows that investment funds have the following characteristics:

- a collective investment undertaking;
- with a defined investment policy;
- which raises capital with a view to investing that capital for the benefit of those investors in accordance with that policy.

The definition of investment funds is broad and includes Luxembourg and foreign funds, closed-ended and open-ended funds, listed and unlisted funds irrespective of the legal form thereof. Investment funds may be divided into two broad categories:

- Undertakings for collective investments in transferable securities (UCITS) that invest into financial instruments, such as stocks, bonds and other securities; and
- Alternative Funds that are created for different types of investments, such as Private Equity, Venture Capital, Real Estate and Infrastructure investments.

According to the commentaries to the ATAD 2 bill, investors in a fund generally do not have effective control over the investments made by the fund that has to invest the contributions of investors in accordance with the fund's investment policy. Therefore, Article 168*ter* LITL provides for a safe harbour rule according to which an investor (be it an individual or an entity) that owns directly or indirectly fewer than 10% of the shares or units in a fund (and that is entitled to less than 10% of the fund's profits) is considered not to act together with the other investors, unless proven otherwise. Here, the burden of proof would be on the Luxembourg tax authorities to evidence that investors are acting together within the meaning of this concept.

Hence, in an investment fund context, the ownership of stakes below 10% should in principle not be relevant when considering a potential aggregation of interests as a consequence of the "acting together" concept. Moreover, when investors in a fund own 10% or more of the shares or fund units (or are entitled to 10% or more of the fund's profits), it has to be analysed on a case-by-case basis whether or not two or more investors are acting together for the purpose of the related party test. Here, the burden of proof that the acting together concept does not apply is on the taxpayer. However, there is no presumption that investors with 10% or more investments would be acting together.

19. Article 168ter (1) No. 18 of the LITL.

20. Article 168*ter* (1) No. 18 of the LITL.

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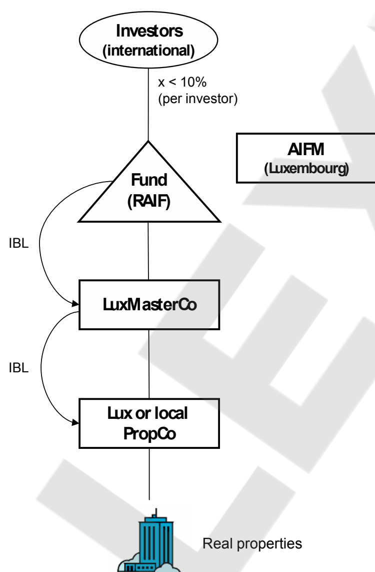
Example: The Luxembourg Investment Fund

A Luxembourg Reserved Alternative Investment Fund ("RAIF") invests into pan-European real estate assets. The fund is managed by a Luxembourg Alternative Investment Fund Manager ("AIFM") that makes investments in accordance with the Fund's investment policy as outlined in the prospectus. Thus, the RAIF qualifies as an investment fund for the purposes of the *de minimis* rule.

The investments of the RAIF are made via a Luxembourg master company ("LuxMasterCo") that operates as the fund's investment platform and via separate property companies ("Lux or local PropCo") that are financed by a mixture of equity and debt instruments (interest-bearing loans, "IBL").

The investors in the fund are institutional investors from several jurisdictions with shareholdings ranging from 2 to 9 per cent. The investors are not actively involved in the investment process (other than confirming the investment policy from time to time) and there exists no special relationships between the investors.



Here, the shareholdings of the investors owning less than 10% should not be added together in accordance with the *de minimis* rule. While the shareholding percentages might need to be aggregated if the Luxembourg, tax authorities can prove that the investors are acting together. In the present case, there exists no indication that investors are acting together within the meaning of Art. 168*ter* (1) No. 18 of the LITL.

In practice, investment funds may involve more than one fund vehicle. Given that institutional investors (insurance companies, pension funds, etc.) have to comply with various regulatory requirements, investment managers may be inclined to accommodate these requirements through the implementation of additional pooling vehicles (so-called "feeder funds") that collect the capital from investors and invest in the main fund. Feeder funds may be established in Luxembourg or abroad in the form of a corporate entity (a corporate fund or standard company), a partnership (a transparent fund or standard partnership) or a contractual fund (e.g. FCP).

The question arises how the *de minimis* rule applies in case of feeder funds. When a feeder fund is classified as opaque from a Luxembourg tax perspective, the related party test (i.e. whether or not the 50% threshold requirement is exceeded) should be applied in regard to the feeder fund. Nevertheless, the inclusion of the income at the level of the feeder fund or the tax (exempt) status of the feeder fund may discharge the application of the hybrid mismatch rules.

In contrast, when the feeder fund is classified as transparent from a Luxembourg tax perspective (for example, a partnership or FCP), the *de minimis* rule should be applied in regard to the investors in the feeder fund (rather than the feeder vehicle itself). Therefore, investors in the feeder vehicle that indirectly own fewer than 10% in the main fund should not be aggregated for the purposes of the related party test. As regards investors that indirectly own 10% or more in the main fund, it has to be analysed on a case-by-case basis whether or not the acting together concept applies. The fact that the feeder fund is managed by a general partner or a management company does not, on its own, suffice to trigger the application of the acting together concept.

Example: The Feeder Fund

Based on the previous example, it is assumed that 60% of the investments in the RAIF are made directly by institutional investors, whereas 40% of the investments are made via a Luxembourg fund in contractual form (*fonds commun de placement*, "FCP") that operates as a feeder fund for those investors that have a preference for such vehicle from a foreign regulatory perspective.

While the FCP owns 40% in the RAIF (and therefore LuxMasterCo), it is assumed that the investors investing into the FCP indirectly own fewer than 10% in the RAIF (applying a look-through approach).

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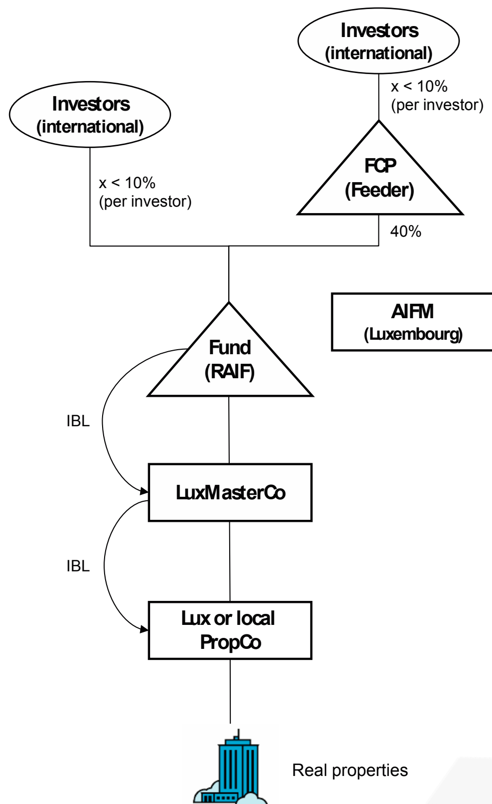

The institutional investors that directly invest into the RAIF should not be aggregated as the *de minimis* rule applies. There further exists no indication that these investors would be acting together.

From a Luxembourg tax perspective, the FCP feeder fund is treated as transparent. Therefore, it is not the 40% investment of the FCP but the individual investments of the investors in the FCP that have to be analysed. As each of the investors in the FCP owns indirectly fewer than 10%, the *de minimis* rule should apply in this case.

As a result, none of the investors owns 10% or more in the RAIF and the participations of different investors should not be aggregated for the purposes of the related party test.

E. Hybrid mismatches

Article 168*ter* (1) No. 2 of the LITL specifies a number of hybrid mismatch situations that come within the scope of the hybrid mismatch rules.

It is interesting to note that payments within the meaning of the hybrid mismatch rules are not limited to interest payments under financial instruments but may also concern current expenditure, such as royalties, rents and other amounts, such as payments for services that may be set-off against ordinary income.[21]

1) Payments under a financial instrument

With regard to financial instruments, a hybrid mismatch means a situation where a payment gives rise to a deduction without inclusion outcome, and:

- the mismatch outcome is attributable to differences in the characterisation of the instrument or the payment made under it; and
- such payment is not included within a reasonable period of time.[22]

The definition of financial instruments is very broad and comprises any instrument to the extent that it gives rise to a financing or equity return that is taxed under the rules for taxing debt, equity or derivatives under the laws of either the payee or payer jurisdictions, including hybrid transfers[23].[24]

The "reasonable period of time" criterion with regard to the inclusion of the income is deemed to be met when:

- the payment is included by the jurisdiction of the payee in a tax period that commences within twelve 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 tax period and the terms of payment adhere to the arm's length standard.[25]

Notably, if the deductible payment is brought into account as ordinary income in at least one jurisdiction, there will be no mismatch for the rule to apply to[26].

Moreover, the hybrid financial instrument rule should only apply where the mismatch in tax treatment is attributable to the terms of the instrument[27]. In contrast, where the tax relief is solely due to the tax status of the payee or the fact that the instrument is held subject to the terms of a special regime, the payment under a financial instrument should not give rise to a hybrid mismatch[28]. This might, for example, be the case when the payee jurisdiction does not levy corporate income tax, the payee

21. See Final Report on BEPS Action 2, p. 51, No. 121.
22. Article 168*ter* (1) No. 2 a) of the LITL.
23. See section 2.1.5.
24. Article 168*ter* (1) No. 11 of the LITL.
25. Article 168*ter* (1) No. 2 a) of the LITL.
26. See Final Report on BEPS Action 2, p. 41, No. 89.
27. See Final Report on BEPS Action 2, p. 41, No. 91.
28. See Final Report on BEPS Action 2, p. 43, No. 96; see recital 16 of ATAD 2.

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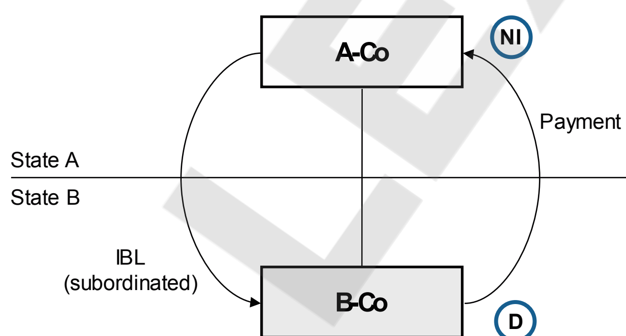
jurisdiction adopted a pure territorial system where the payment is treated as non-taxable foreign source income or the recipient is tax exempt (for example, pension funds, insurance companies or sovereign wealth funds that benefit from a special tax exemption).

However, a payment under a financial instrument will not be considered as included when the payee jurisdiction subjects the payment to taxation at a rate below the standard tax rate. This would, for example, be the case when the payment qualifies for a tax relief based on the way that payment is characterised under the laws of the payee jurisdictions[29]. Where a deductible payment benefits from a partial tax exemption or a reduced tax rate in the payee jurisdiction, the tax adjustment (i.e. a denial of deductibility) should generally be limited to what is necessary for neutralising the mismatch outcome between the payer and payee jurisdiction. Thus, a deduction should remain available to the extent that the payment is subject to tax in the payee jurisdiction at the standard tax rate.[30]

Example: The Hybrid Financing Instrument

A company resident in State A ("A-Co") has a 100% participation in a company resident in State B ("B-Co"). A-Co finances B-Co with a subordinated loan ("IBL") that is classified as a debt instrument under the laws of State B. In contrast, under the laws of State A, the loan is classified as an equity interest and the payments under the instrument benefit from an exemption under the domestic participation exemption regime.



As a consequence, the payment will be deductible in State B (D), whereas the payment will not be included in the taxable basis of A-Co in State A (NI), resulting in a deduction without inclusion outcome (D/NI).

In a mere EU context, payments under financial instruments should not give rise to hybrid mismatch outcomes within the meaning of article 168*ter* of the LITL. This is because EU Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, as amended (the "Parent-Subsidiary Directive") already required EU Member States to implement an anti-abuse provision under which the tax exemption applicable to dividend income is denied when these payments are deductible at the level of the paying EU subsidiary. Thus, this provision eliminates potential mismatch outcomes through the linking of the tax treatment in the payee jurisdiction to that in the payer jurisdiction.[31]

2) Payments to a hybrid entity

A "hybrid entity" is, generally speaking, an entity that is treated as fiscally transparent in one jurisdiction and opaque in another jurisdiction. Article 168*ter* (1) No. 11 of the LITL defines hybrid entities as any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure of one or more other persons under the laws of another jurisdiction.

According to Article 168*ter* (1) No. 2 b) of the LITL, a hybrid mismatch exists where a payment to a hybrid entity gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction where the hybrid entity is established or organised and the jurisdiction of any person with a participation in that hybrid entity.

This type of hybrid mismatch involves a so-called reverse hybrid entity which is any entity that is treated as transparent under the laws of the jurisdiction where it is established but as a separate entity (i.e. opaque) under the laws of the jurisdiction of the investor(s)[32]. Thus, a deductible payment made to a reverse hybrid entity may give rise to a mismatch in tax outcomes where that payment is neither included in ordinary income in the establishment jurisdiction of the hybrid entity nor in the jurisdiction of any investor therein[33]. As for the other hybrid entity payment rules, the reverse hybrid rule can apply to a broad range of deductible payments including interest, royalties, rents and fees for services.

29. Article 168*ter* (1) No. 2 a) of the LITL; see Final Report on BEPS Action 2, p. 30, No. 41.
30. See Final Report on BEPS Action 2, p. 31, No. 43.
31. This anti-abuse rule has been included in Article 166 (2*bis*) of the LITL.
32. See Final Report on BEPS Action 2, p. 56, No. 140.
33. See Final Report on BEPS Action 2, p. 55, No. 139.

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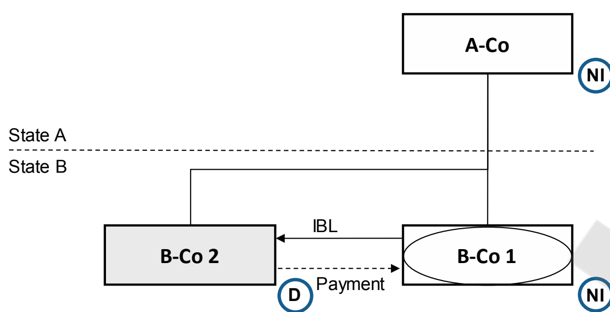
Example: Payments to a Hybrid Entity

A company resident in State A ("A-Co") owns two participations in entities residents in State B ("B-Co 1" and "B-Co 2", respectively). While B-Co 2 is a corporate taxpayer under the domestic tax law of State B, B-Co 1 is treated as fiscally transparent. Under the laws of State A, both subsidiaries are treated as opaque from a tax perspective. Thus, B-Co 1 is a hybrid entity within the meaning of the hybrid mismatch rules (i.e. a reverse hybrid entity). B-Co 1 finances B-Co 2 with an interest-bearing loan ("IBL").



In this example, the interest paid by B-Co 2 to B-Co 1 is tax deductible (D) at the level of B-Co 2. However, neither at the level of B-Co 1 nor at the level of A-Co, the interest payment is included in the taxable income (NI), resulting in a deduction without inclusion outcome (D/NI).

The scope of this hybrid mismatch rule is, however, subject to a twofold limit:

- First, if the payment is treated as taxable income in at least one jurisdiction (including the potential application of CFC rules at the level of a parent company), there will be no hybrid mismatch within the meaning Article 168*ter* (1) No. 2 b) of the LITL[34].
- Second, if the payment is not treated as taxable income in any jurisdiction, this rule should not apply unless the payment would have been included as ordinary income if it had been paid directly to the investor (i.e. the interposition of the reverse hybrid entity must have been necessary to bring about the mismatch in tax outcomes). In other words, the hybrid mismatch rules do not apply if the payment would not be taxed in any case due to the tax-exempt status of the payee under the laws of any payee jurisdiction (i.e. the payee jurisdiction does not levy corporate income tax, the payee jurisdiction adopted a territorial system where the payment is treated as non-taxable foreign source income or the payee is tax exempt[35]).

Example: Investor Resident in an Offshore Jurisdiction

Based on the previous example, if A-Co were tax resident in a jurisdiction that does not levy corporate income tax, the direct payment to A-Co would not be taxable and, therefore, the hybrid mismatch rule would not apply.

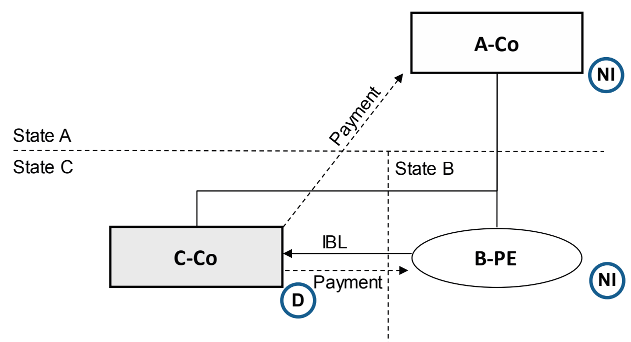
The fact that the accrued income of the reverse hybrid entity will be taxable as ordinary income upon distribution to the investor should generally suffice to show that the payment does not give rise to a deduction without inclusion (D/NI) outcome (in particular, when distributions take place within a reasonable period of time[36]).

3) Payments to an entity with one or more PEs

A hybrid mismatch may further involve a payment to an entity with one or more PEs that gives rise to a deduction without inclusion provided that the mismatch outcome is the result of differences in the allocation of payments between the head office and the PE (or between two or more PEs of the same entity) under the laws of the jurisdictions where the entity operates[37].

Example: Payments to an Entity with a PE

A company resident in State A ("A-Co") has a subsidiary in State C ("C-Co") and a PE in State B ("B-PE") through which A-Co is financing C-Co with an interest-bearing loan ("IBL"). State A and State B concluded a tax treaty under which profits attributable to B-PE may be taxed in State B, whereas State A adopted the exemption method for the elimination of double taxation.



In the present example, the interest paid by C-Co to B-PE is deductible in State C (D). It is further assumed

34. See Final Report on BEPS Action 2, p. 57, No. 149
35. See Final Report on BEPS Action 2, p.55, No. 139, p. 60, No. 166; see recital 18 of ATAD 2.
36. See, for example, page 11 of the Opinion of the Luxembourg State Council of 10 December 2019.
37. Article 168*ter* (1) No. 2 c) of the LITL.

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that the interest is not included in the tax base of B-PE (NI) since under the domestic tax law of State B, the income is deemed to be attributed to A-Co. In State A, the profits attributable to B-PE are exempt (NI) in accordance with the applicable tax treaty. Hence, the hybrid mismatch results in a deduction without inclusion outcome (D/NI) because of differences in the allocation of payments between the head office and PE.

However, the definition of hybrid mismatch should only apply when the mismatch outcome is a result of differences in the rules governing the allocation of payments under the laws of the two jurisdictions and a payment should not give rise to a hybrid mismatch that would have arisen in any event due to the tax-exempt status of the payee under the laws of any payee jurisdiction (i.e. the payee jurisdiction does not levy corporate income tax, the payee jurisdiction adopted a territorial system where the payment is treated as non-taxable foreign source income or the payee is tax exempt).[38]

Example: Payments to an Entity with a PE

Based on the previous example, if A-Co were resident in a State that does not levy corporate tax, the application of the hybrid mismatch rules would be discharged based on the tax status of the investor.

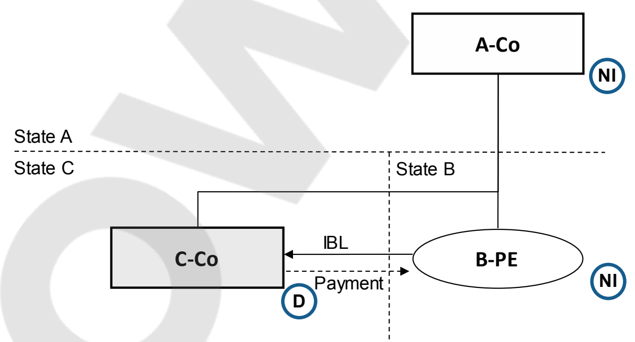
4) Payments to a disregarded PE

Hybrid mismatch situations may also involve a disregarded PE which is defined as any arrangement that is treated as giving rise to a PE under the laws of the head office jurisdiction and is not treated as giving rise to a PE under the laws of the other jurisdiction (i.e. the assumed host State of the disregarded PE from the perspective of the head office jurisdiction).

A hybrid mismatch within the meaning of Article 168*ter* (1) No. 2 d) of the LITL arises when a payment gives rise to a deduction without inclusion as a result of a payment to a disregarded PE. In these circumstances, the deduction without inclusion outcome is generally a result of the non-recognition of the PE in its assumed host State (in accordance with the domestic tax law of the host State) and the exemption of the income attributable to the disregarded PE (from the perspective of the residence State of the enterprise) in accordance with an applicable tax treaty.

Example: Payments to a Disregarded PE

A company resident in State A ("A-Co") has a subsidiary in State C ("C-Co") and a PE in State B ("B-PE") through which A-Co is financing C-Co with an interest-bearing loan ("IBL"). State A and State B concluded a tax treaty under which profits attributable to B-PE may be taxed in State B, whereas State A adopted the exemption method for the elimination of double taxation.



The interest paid by C-Co to B-PE is deductible in State C (D). In State A, the profits attributable to B-PE are exempt (NI) under the tax treaty concluded between State A and State B.

In the present example, it is assumed that the interest is not taxable in State B (NI) as A-Co is considered to have no PE in State B (under the domestic tax law of State B). Hence, this hybrid mismatch results in a deduction without inclusion outcome (D/NI) because of differences in the recognition of a PE under the laws of State A and State B.

Nevertheless, the hybrid mismatch rule should not apply as long as the mismatch would have arisen in any event due to the tax-exempt status of the payee under the laws of any payee jurisdiction (i.e. the payee jurisdiction does not levy corporate income tax, the payee jurisdiction adopted a territorial system where the payment is treated as non-taxable foreign source income or the payee is tax exempt).[39]

5) Payments by a hybrid entity

A hybrid mismatch also exists where payments made by a hybrid entity give rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction.[40]

38. See recital 18 of ATAD 2.
39. See recital 19 of ATAD 2.
40. Article 168*ter* (1) No. 2 e) of the LITL.

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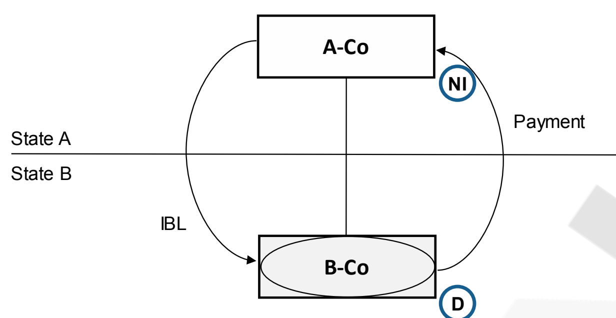
Where the mismatch outcome is a consequence of the non-allocation of the payment, the payee jurisdiction is the jurisdiction where the payment is treated as being received under the laws of the payer jurisdiction.[41]

Example: Payments by a Hybrid Entity

A company resident in State A ("A-Co") has a subsidiary resident in State B ("B-Co"). A-Co finances B-Co with an interest-bearing loan ("IBL"). While under the domestic tax law of State A, B-Co is considered to be fiscally transparent, under the domestic tax law of State B, B-Co is considered to be opaque. Accordingly, B-Co is a hybrid entity.



The payment made by B-Co to A-Co is deductible in State B (D), whereas in State A the same payment is disregarded (NI) in view of the transparency of B-Co under the domestic tax law of State A. Hence, this hybrid mismatch results in a deduction without inclusion outcome (D/NI) because of differences in the classification of B-Co under the laws of State A and State B.

No hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction (i.e. the payee jurisdiction does not levy corporate income tax, the payee jurisdiction adopted a territorial system where the payment is treated as non-taxable foreign source income or the payee is tax exempt[42]).

The deduction in the payer jurisdiction does not result in a deduction without inclusion outcome if it is only offset against dual inclusion income. A mismatch outcome would only arise if (and to the extent) the payer jurisdiction allows the deduction in respect of the payment to be set off against an amount that is not dual-inclusion income.[43] An item of income should be treated as dual inclusion income if it is taken into account as income under the laws of both the payer and payee jurisdiction[44].

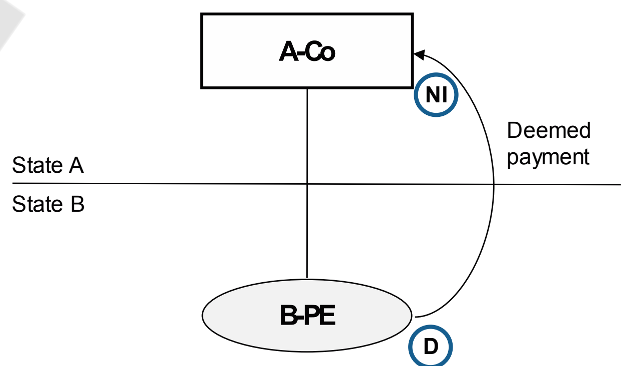
6) Deemed payments between the head office and a PE

A hybrid mismatch may also exist in case of a deemed payment between the head office and a PE (or between two or more PEs) that gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction[45].

When the mismatch outcome is a consequence of the non-allocation of the deemed payment, the payee jurisdiction is the jurisdiction where the payment is treated as being received under the laws of the payer jurisdiction.[46]

Example: Deemed Payments in a PE Context

A company resident in State A ("A-Co") has a PE in State B ("B-PE") through which trading activities are performed. State A and State B concluded a tax treaty under which profits attributable to B-PE may be taxed in State B whereas State A adopted the exemption method for the elimination of double taxation. Under the domestic tax law of State B, it is assumed that B-PE is partly financed with interest-free debt and a deemed interest payment is made to A-Co corresponding to the arm's length interest rate.



The deemed payment by B-PE to A-Co is deductible in State B (D), whereas in State A the same payment is not taken into consideration (NI) in accordance with the applicable tax treaty. Therefore, the deemed payment by B-PE results in a deduction without inclusion outcome (D/NI).

However, no hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction (i.e. the payee jurisdiction does not levy corporate income tax, the payee jurisdiction adopted a ter-

41. See recital 20 of ATAD 2.
42. See Final Report on BEPS Action 2, p. 49; see recital 20 of ATAD 2.
43. See Final Report on BEPS Action 2, p. 49; see recital 20 of ATAD 2.
44. See Final Report on BEPS Action 2, p. 50, No. 117, p. 51, No. 125.
45. Article 168*ter* (1) No. 2 f) of the LITL.
46. See recital 20 of ATAD 2.

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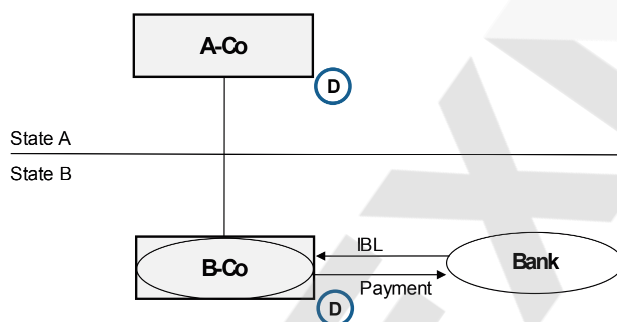
ritorial system where the payment is treated as non-taxable foreign source income or the payee is tax exempt). Moreover, a mismatch outcome would only arise to the extent that the payer jurisdiction allows the deduction in respect of the payment to be set off against an amount that is not dual-inclusion income[47].

7) Double deductions

The last category of hybrid mismatches concerns situations where double deduction outcomes occur regardless of whether they arise as a result of payments, expenses that are not treated as payments under domestic tax law or as a result of amortisation or depreciation losses.[48]

Example: Double Deductions

A company resident in State A ("A-Co") has a subsidiary resident in State B ("B-Co"). B-Co obtained an interest-bearing loan ("IBL") from a bank. While under the domestic tax law of State A, B-Co is considered to be fiscally transparent, under the domestic tax law of State B, B-Co is considered to be opaque. In view of this different classification, B-Co is a hybrid entity.



The interest paid by B-Co to the Bank is deductible (D) in State B given that B-Co is treated as opaque under the domestic tax law of State B. In addition, the same interest payment is deductible (D) in State A where B-Co is treated as transparent for tax purposes. Therefore, the interest payments to the bank result in the present example to a double deduction outcome (DD).

A payment results in a hybrid mismatch where the deduction for the payment may be set-off under the laws of both the parent and the payer jurisdiction against income that is not included in the tax base in both jurisdictions (i.e. dual inclusion income). Conversely, no hybrid mismatch will arise to the extent such deduction is set-off only against dual inclusion income.[49]

F. Hybrid Transfers

A hybrid transfer is any arrangement to transfer a financial instrument where the underlying return on the transfer of the financial instrument is treated for tax purposes as derived simultaneously by more than one of the parties to the arrangement.[50] Here, the laws of two jurisdictions take opposing views on whether the transferor and transferee have ownership of the underlying asset as a consequence of the economics of the transaction and the way it is structured. In this regard, ownership refers to the economic ownership of the payment as opposed to the legal ownership of the asset itself[51].

The payment under the hybrid transfer may give rise to a deduction without inclusion outcome where the payer claims a deduction while the payee treats the payment as a return on the underlying instrument itself (on which grounds the payment is excluded or exempt from taxation). Hybrid transfers may further result in the generation of surplus tax credit for the tax withheld at source on the underlying instrument[52].

While a hybrid transfer may arise in the context of an ordinary sale and purchase agreement when there is a conflict in the determination of the timing of the asset transfer, the hybrid transfer rules are particularly targeted at sale and repurchase (Repo) and security lending transactions where the rights and obligations of the parties are structured in such a way that the transferor remains exposed to the financing or equity return on the financial instrument transferred under the arrangement[53].

As hybrid transfers are treated as a type of financial instrument, a deduction without inclusion outcome under a hybrid transfer will only be subject to adjustments if and to the extent that the mismatch can be attributed to differences in the tax treatment of the arrangement under the laws of the payer and payee jurisdictions[54].

A payment representing the underlying return on a transferred financial instrument shall not, however, give rise to a hybrid mismatch where the payment is made by a financial trader under an on-market hybrid transfer provided that the payer jurisdiction requires the financial trader to include all amounts received as

47. See recital 20 of ATAD 2.
48. Article 168*ter* (1) No. 2 g) of the LITL, see recital 21 of ATAD 2.
49. See Final Report on BEPS Action 2, p. 67; see recital 21 of ATAD 2.
50. Article 168*ter* (1) No. 13 of the LITL
51. See Final Report on BEPS Action 2, p. 38, No. 72
52. See recital 23 of ATAD 2; see Final Report on BEPS Action 2, p. 26, No. 23.
53. See Final Report on BEPS Action 2, p. 38, No. 73.
54. See Final Report on BEPS Action 2, p. 26, No. 24.

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income in relation to the transferred financial instrument[55]. On-market hybrid transfers are defined as any hybrid transfer that is entered into by a financial trader in the ordinary course of business and not as part of a structured arrangement.[56]

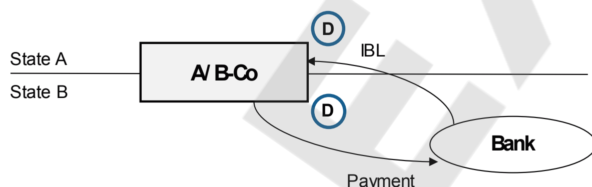
G. Tax residency mismatches

Tax residency mismatches involve a situation where an entity is considered to be resident for tax purposes in two or more jurisdiction (based on the domestic tax laws of these jurisdictions).

A dual resident mismatch may give rise to double deduction outcomes when payments are deductible under the laws of both jurisdictions where the payer is resident. The meaning of deductible payments generally covers an entity's expenditures, such as interest payments, royalties, rents and other amounts, such as payments for services that may be set-off against ordinary income under the laws of the payer jurisdiction in the period in which they are treated as made[57].

Example: Tax Residency Mismatch

A company that has its seat in State A is effectively managed in State B ("A/B-Co"). On this basis, it is assumed that A/B-Co is resident for tax purposes in State A and State B in accordance with the domestic tax laws of both jurisdictions. State A and State B did not conclude a tax treaty. A/B-Co obtained a loan from a bank.



The interest paid by A/B-Co to the bank is deductible in State A and State B, resulting in a double deduction (DD).

In a tax treaty context, cases of dual residence are settled through the application of the so-called (corporate) tiebreaker rule that is included in all tax treaties concluded by Luxembourg. According to the tiebreaker rule, an entity that is a resident of both Contracting States shall be deemed to be (only) a resident of the Contracting State in which the entity's place of management is situated[58]. Thus, when the tiebreaker rule applies, there can be no tax residency mismatch.

While the 2017 revision of the OECD Model provides for a new rule regarding the determination of the State of residence in case of dual residence of entities (i.e. determination by mutual agreement) that has been developed as part of the OECD's work on BEPS Action 6 (Prevention on Tax Treaty Abuse), States are free to keep (or, with regard to new tax treaties, include) a provision that relies on the place of effective management as a tiebreaker[59].

H. Structured arrangements

The hybrid mismatch rules also apply to any person who is a party to a "structured arrangement" regardless of any association with the other party thereto.[60] A "structured arrangement" means an arrangement involving a hybrid mismatch where:

(i) the mismatch outcome is priced into the terms of the arrangement or

(ii) an arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch[61].

The test as to whether an arrangement is structured is objective and does not consider the parties' intention[62]. Therefore, if the tax benefit of the mismatch is priced into the arrangement or if a reasonable person, looking at the facts of the arrangement, would otherwise conclude that it was designed to engineer a mismatch in tax outcomes, then the arrangement should be caught by the definition[63].

The hybrid mismatch will be priced into the terms of the arrangement if the mismatch has been factored into the calculation of the return under the arrangement (i.e. the taxpayer benefits from the tax advantage). This test looks at the actual terms of the arrangement with a view to determining whether the pricing of the transaction is different from what would have been agreed had the mismatch not arisen[64].

In contrast, the "designed to produce a hybrid mismatch" test is a wider test that looks at:

55. Article 168*ter* (1) No. 2 a) of the LITL.
56. Article 168*ter* (1) No. 14 of the LITL.
57. See Final Report on BEPS Action 2, p. 78, No. 222.
58. Article 4 (3) of the OECD Model (2014 version).
59. See Paragraph 24.5 of the Commentary on Article 4 of the OECD Model Tax Convention (2017 version).
60. See Final Report on BEPS Action 2, p. 105, No. 318.
61. Article 168*ter* (1) No. 16 of the LITL.
62. See Final Report on BEPS Action 2, p. 106, No. 319.
63. See Final Report on BEPS Action 2, p. 106, No. 321.
64. See Final Report on BEPS Action 2, p. 106, No. 323.

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– the relationship between the parties;

– the circumstances under which the arrangement was entered into;

– the steps and transactions that were undertaken to put the arrangement into effect; and

– the terms of the arrangement itself and the economic and commercial benefits of the transaction[65].

When a reasonable person, looking at the facts of the arrangement, would conclude that it was designed to engineer a mismatch in tax outcomes, then the arrangement should be caught by the definition irrespective of the actual intention or understanding of the taxpayer when entering into an arrangement[66].

According to the Final Report on BEPS Action 2, facts and circumstances that indicate that an arrangement has been designed to produce a hybrid mismatch include any of the following:

a) an arrangement is designed, or is part of a plan, to create a hybrid mismatch. This assumes a person with material involvement in, or awareness of, the design of the arrangement (such as a tax adviser) has identified, before the arrangement was entered into, that it will give rise to a mismatch outcome[67];

b) an arrangement that incorporates a term, step or transaction used in order to create a hybrid mismatch. Here, a term, step or transaction will be treated as inserted into an arrangement to produce a mismatch outcome if that mismatch would not have arisen in the absence of that term, step or transaction and where there was no substantial business, commercial or other reason for inserting that term into the arrangement or undertaking that step or transaction[68];

c) an arrangement that is marketed, in whole or in part, as a tax-advantaged product where some or all of the tax advantage derive from the hybrid mismatch. This would be analysed based on written, electronic or oral communication provided to the parties[69];

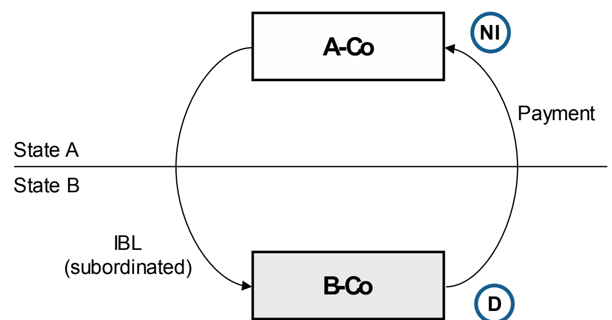
d) an arrangement that is primarily marketed to taxpayers in a jurisdiction where the hybrid mismatch arises. Here, the fact that the arrangement is also available to taxpayers in other jurisdictions who do not benefit from the mismatch will not prevent that transaction from being treated as part of a structured arrangement if the majority of the arrangements, by number or value, are entered into with taxpayers located in jurisdictions that do benefit from the mismatch;

e) an arrangement that contains features that alter the terms under the arrangement, including the return, in the event that the hybrid mismatch is no longer available (i.e. this would be an indication that the benefit of the hybrid mismatch has been priced into the arrangement[70]); or

f) an arrangement that would produce a negative return absent the hybrid mismatch. In these circumstances, it would be uneconomic for the taxpayer to enter into the arrangement absent the benefit under the hybrid mismatch[71,72].

Example: Hybrid Mismatch Priced Into the Terms of the Arrangement

A company resident in State A ("A-Co") granted a subordinated loan ("IBL") to a company resident in State B ("B-Co"). Both companies are unrelated parties. While the subordinated loan is treated as a debt instrument under the laws of State B, in State A, it is treated as an equity instrument and payments made under the loan benefit from the participation exemption regime. It is assumed that the interest charged under the loan corresponds to the market rate of interest minus 50% of the tax savings generated by A-Co due to the tax exemption.



Here, the payment results in a deduction without inclusion (D/NI) outcome that is a hybrid mismatch and the tax benefit has been priced into the arrangement. Consequently, the subordinated loan should be a structured arrangement within the meaning of Article 168*ter* (1) No. 17 of the LITL.

65. See Final Report on BEPS Action 2, p. 107, No. 326.
66. See Final Report on BEPS Action 2, p. 106, No. 321.
67. See Final Report on BEPS Action 2, p. 108, No. 330.
68. See Final Report on BEPS Action 2, p. 108, No. 333.
69. See Final Report on BEPS Action 2, p. 109, No. 335.
70. See Final Report on BEPS Action 2, p. 110, No. 338.
71. See Final Report on BEPS Action 2, p. 110, No. 340.
72. See Final Report on BEPS Action 2, p. 105.

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The structured arrangement definition does not, however, apply to a taxpayer who is not a party to the arrangement[73]. To be considered as a party to an arrangement requires that a person has a sufficient level of involvement in the arrangement to understand how it has been structured and what its tax effects might be[74]. Nevertheless, this test is not intended to impose an obligation on that person to undertake additional due diligence on a commercial transaction over and above what would be expected of a reasonable and prudent person[75].

I. Imported Hybrid Mismatches

Imported hybrid mismatches shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of EU Member States through the use of a non-hybrid instrument. In other words, the deductible payment in a Member State can be used to fund expenditure incurred in relation to a hybrid mismatch.[76]

The imported hybrid mismatch rule disallows deductions regarding a broad range of payments, such as interest, royalties, rents and payments for services if the income from such payments is set-off, directly or indirectly, against a deduction that arises under a hybrid mismatch arrangement in a third State[77]. The imported mismatch rule applies to both intragroup and structured imported mismatch arrangements[78]. A hybrid deduction does not, however, arise to the extent a disregarded or deductible hybrid payment is set-off against dual inclusion income[79].

Imported hybrid mismatches have three basic elements:

(i) a deductible payment made by a taxpayer that is subject to the hybrid mismatch rules and which is included in the taxable income under the laws of the payee jurisdiction (that is the "imported mismatch payment"). Here, the hybrid mismatch rules would not deny the deductibility of this payment in the absence of a direct hybrid mismatch;

(ii) a deductible payment made by a person that is not subject to the hybrid mismatch rules which directly gives rise to a mismatch outcome (that is a "direct hybrid deduction"). This hybrid mismatch is not neutralised in the absence or non-application of hybrid mismatch rules in a third State; and

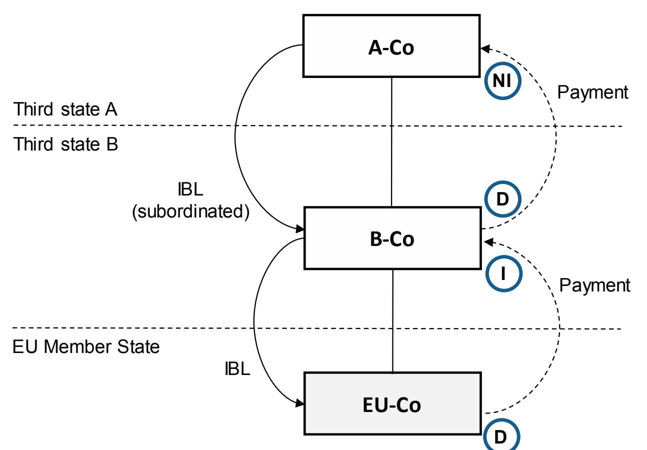
(iii) a nexus between the imported mismatch payment and the direct hybrid deduction that shows how the imported mismatch payment has been set-off directly or indirectly against that hybrid deduction. In practice, this tracing exercise may be complex, depending on the number of payments and arrangements involved[80].

In other words, an imported hybrid mismatch may arise when the domestic tax laws of two third States do not include hybrid mismatch rules that neutralise the effects of a hybrid mismatch and the income derived from a deductible payment incurred in an EU Member State finances the deductions incurred under the hybrid mismatch.

Example: Imported Deduction without Inclusion

A company resident in third State A ("A-Co") finances its subsidiary resident in third State B ("B-Co") with a subordinated loan ("IBL (subordinated)"). Under the domestic tax law of third State B, the IBL is classified as a debt instrument and related interest expenses are deductible for tax purposes. In contrast, under the domestic tax law of third State A, the IBL is treated as equity and payments received from B-Co are treated as dividends that benefit from a tax exemption in accordance with the participation exemption regime applicable in third State A.

B-Co uses the funds received under the IBL (subordinated) to grant an interest-bearing loan ("IBL") to its subsidiary that is resident in an EU Member State ("EU-Co"). In both third State B and the EU Member State, the IBL is classified as a debt instrument and related interest expenses are, respectively, deductible and included in ordinary income for tax purposes.



73. See Final Report on BEPS Action 2, p. 106, No. 320.
74. See Final Report on BEPS Action 2, p. 110, No. 342.
75. See Final Report on BEPS Action 2, p. 301.
76. See recital 25 of ATAD 2.
77. See Final Report on BEPS Action 2, p. 83, No. 234, p. 85, No. 242.
78. See Final Report on BEPS Action 2, p. 83.
79. See Final Report on BEPS Action 2, p. 85, No. 243.
80. See Final Report on BEPS Action 2, p. 85, No. 241; the Final Report on BEPS Action 2 also provides tracing and priority rules that a jurisdiction should apply to determine the extent of the adjustment required under the imported hybrid mismatch rules, see Final Report on BEPS Action 2, p. 86, No. 246 f.

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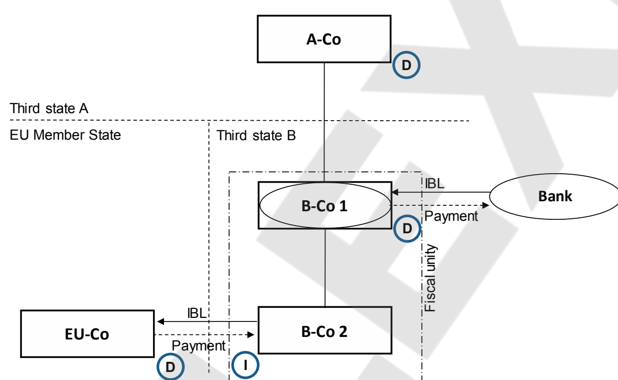
In the present example, a hybrid mismatch occurring between A-Co and B-Co is imported to the EU Member State as the tax-deductible expenses at the level of EU-Co finance expenditure incurred by B-Co in relation to a hybrid financial instrument.

Example: Imported Double Deduction

A company resident in an EU Member State ("EU-Co") is an associated enterprise of a company resident in third State A ("A-Co") and two subsidiaries thereof that are resident for tax purposes in third State B ("B-Co 1" and "B-Co 2"). B-Co 1 and B-Co 2 formed a fiscal unity for corporate tax purposes in third State B. Thus, both companies are taxed in State B on a consolidated basis.

While under the domestic tax law of State A, B-Co 1 is considered to be fiscally transparent, under the domestic tax law of State B, B-Co 1 is considered to be opaque. Accordingly, B-Co 1 is a hybrid entity.

B-Co 1 is financed by a bank loan that is used to finance B-Co 2 with equity. B-Co 2 in turn uses the funds received from B-Co 1 to finance EU-Co with an interest-bearing loan ("IBL"). Under the domestic tax law of the EU Member State, the IBL is treated as debt and related interest expenses are deductible for tax purposes.



The interest paid by B-Co 1 to the Bank is deductible (D) in third State B given that B-Co is treated as opaque under the domestic tax law of third State B. The interest expenses incurred by B-Co 1 may offset any income realised in the fiscal unity. In addition, the same interest payment is deductible (D) in State A where B-Co 1 is treated as transparent from a tax perspective. Therefore, the interest payments to the bank results in a double deduction (DD).

While the interest expenses in regard to the IBL granted by B-Co 2 to EU Co are generally deductible, in the present example, these payments finance expenditure incurred by B-Co 1 in relation to the bank loan that give rise to a double deduction. Thus, in this case a double deduction that would otherwise be imported to the EU Member State should be neutralised through the application of the imported hybrid mismatch rule.

The imported hybrid mismatch rule evidently creates a lot of complexity that starts with the identification of the payment that gives rise to a (direct) hybrid mismatch and continues with the determination as to what extent the deductible payment made under that hybrid arrangement has been funded (either directly or indirectly) out of payments by a taxpayer that are subject to the imported mismatch rule[81].

J. Limits of the hybrid mismatch rules

The purpose of Article 168*ter* of the LITL is the neutralisation of mismatch outcomes that occur in specific hybrid mismatch situations. At the same time, the hybrid mismatch rules should not create economic double taxation.[82] Therefore, the scope of the hybrid mismatch rules is limited as follows:

- **Deductible payments**

The hybrid mismatch rules are exclusively targeted at "deductible payments". Thus, non-deductible payments, such as interest expenses incurred in relation to tax exempt income may not come within the scope of Article 168*ter* of the LITL.

- **Timing Differences**

Jurisdictions may use different tax periods and have different rules for recognising when items of income or expenditure have been derived or incurred. However, timing differences should generally not be treated as giving rise to mismatches in tax outcomes as long as the income is included within a reasonable period of time[83].

A payment under a financial instrument is deemed to be included within a reasonable period of time if such payment is included by the jurisdiction of the payee in a tax period that commences within twelve months of the end of the payer's tax period[84]. Alternatively, it has to be evidenced by the taxpayer that it is reasonable to expect that the payment will be included by the jurisdiction of the

81. See Final Report on BEPS Action 2, p. 84, No. 235.
82. See, for example, Final Report on BEPS Action 2, p. 29, No. 36 and p. 86, No. 245.
83. See recital 22 of ATAD 2; see also pages 8 and 11 of the Opinion of the Luxembourg State Council of 10 December 2019.
84. Article 168*ter* (1) No. 2 a) of the LITL.

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payee in a future tax period and the terms of payment adhere to the arm's length principle.

- **ATAD 2 and the effect of other EU Directives**

Where the provisions of another EU Directive, such as the Parent-Subsidiary Directive[85], lead already to the neutralisation of the mismatch in tax outcomes, there should be no scope for the application of the hybrid mismatch rules.[86]

Under Article 166 of the LITL (that is the domestic implementation of the Parent-Subsidiary Directive, as amended), a dividend payment only benefits from the participation exemption regime if the payment was not deductible at the level of the distributing EU subsidiary. Similar provisions should be included in the tax laws of all EU Member States and take precedence over the hybrid mismatch rules[87].

- **Inclusion of income**

A deduction without inclusion outcome assumes that a deductible payment is not included in any jurisdiction where that payment (or deemed payment) is received (or is treated as being received) under the laws of any other jurisdiction.[88]

On the contrary, no mismatch outcome exists if the payment is included in the taxable income in at least one jurisdiction. Thus, the inclusion in any jurisdiction is sufficient to discharge the application of the hybrid mismatch rules.[89] Income is deemed to be included where CFC rules have the effect of including a payment in the ordinary income of a (indirect) parent company[90].

The inclusion of income does not require effective taxation though. Instead, the mere inclusion in the ordinary income of the payee(s) suffices irrespective of whether or not the income is offset by tax losses incurred in the same or previous tax periods.

- **Tax Status of the Payee**

A payment should not be treated as giving rise to a hybrid mismatch if the non-inclusion of a payment would have arisen in any event due to the tax status of the payee under the laws of the payee jurisdiction. Accordingly, the following payments should be deemed not to give rise to a deduction without inclusion outcome:

- payments to a taxpayer that is resident in a jurisdiction that does not levy corporate income tax;
- payments to a taxpayer that is resident in a jurisdiction with a pure territorial regime where the income is excluded or exempt as foreign source income; and
- payments to tax-exempt investors, such as investment funds, pension funds or sovereign wealth funds that benefit from a tax exemption in their State of residence.

When the tax status of the payee discharges the application of the hybrid mismatch rules, it is not necessary to demonstrate that no hybrid mismatch would have arisen if the payee was a fully taxable company (also referred to as "counterfactual test").

Furthermore, as regards payments under financial instruments, a payment should not be considered as giving rise to a mismatch outcome if the latter is solely due to the fact that the instrument is held subject to the terms of a special regime[91].

- **Dual inclusion income**

With regard payments by a hybrid entity[92], deemed payments between a head office and a PE[93] and double deductions[94], the hybrid mismatch rules only apply if and to the extent a deduction is set-off against income that is not dual inclusion income (that is any item of income that is included under the laws of both jurisdictions where the mismatch outcome arises). Thus, the deduction of payments from dual-inclusion income does not trigger the application of the hybrid mismatch rules.

- **Transfer Pricing Adjustments**

Differences in tax outcomes that are solely attributable to transfer pricing adjustments do not fall within the scope of the hybrid mismatch rules. Therefore, downward adjustments that are treated as deductible expenses by a taxpayer should not trigger the application of the hybrid mismatch rules even if no corresponding transfer pricing adjustment is made in the other jurisdiction[95].

- **Allocation of Taxing Rights Under Tax Treaties**

Any adjustment required under the hybrid mismatch rules should in principle not affect the allocation of taxing rights between Contracting States under an applicable

85. Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (as amended).
86. See recital 30 of ATAD 2.
87. Article 166 (2*bis*) of the LITL.
88. Article 168*ter* (1) No. 6 of the LITL.
89. See Final Report on BEPS Action 2, p. 41, No. 89; p. 57, No. 149.
90. See Final Report on BEPS Action 2, p. 57, No. 150; see pages 9 and 10 of the Opinion of the Luxembourg State Council of 10 December 2019.
91. See Final Report on BEPS Action 2, p. 43, No. 96; see recital 16, 18 and 20 of ATAD 2.
92. Article 168*ter* (1) No. 2 e) of the LITL.
93. Article 168*ter* (1) No. 2 f) of the LITL.
94. Article 168*ter* (1) No. 2 g) of the LITL.
95. See recital 22 of ATAD 2, see Final Report on BEPS Action 2, p. 33, No. 53.

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tax treaty. This confirms that tax treaty law is generally superior to the domestic tax laws of the Contracting States[96].

III. TAX TREATMENT OF HYBRID MISMATCHES

A. *Opening comments*

Article 168*ter* of the LITL aims at neutralising the effects of hybrid mismatches. With regard to deduction without inclusion (D/NI) and double deduction (DD) outcomes, the new hybrid mismatch rules provide for linking rules that align the tax treatment of an instrument, an entity or a PE with the tax treatment in the counterparty jurisdiction. This mechanism is meant to neutralise the mismatch outcomes, to prevent the application of the hybrid mismatch rules by more than one country (to the same arrangement) and to avoid economic double taxation.

When a hybrid mismatch involves a third State, ATAD 2 places the responsibility to neutralise the effects of hybrid mismatches, including imported hybrid mismatches, on the EU Member States.

The adjustment should, however, be no more than what is necessary to neutralise the hybrid mismatch and not result in economic double taxation[97]. When, for example, the payee jurisdiction only provides taxpayers with a partial exemption or a reduced rate on a payment under a hybrid financial instrument, the amount of the deduction to be denied should be no more than what is necessary to balance the amount of mismatch in tax outcomes between the payer and the payee jurisdiction[98].

B. *Double Deductions*

Where a hybrid mismatch results in a double deduction, the mismatch should be neutralised as follows:

a) the payment, expenses or losses are not deductible at the level of the taxpayer that is the investor (primary rule); or

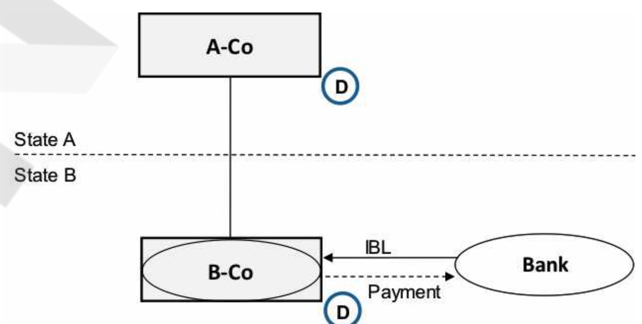
b) where a payment, expenses or losses are deductible in the jurisdiction of the investor, the payment, expenses or losses are not deductible at the level of the paying taxpayer (secondary rule)[99].

Article 168*ter* (3) of the LITL introduces a linking rule that aligns the tax outcomes in the payer and payee jurisdictions. When Luxembourg is the payee jurisdiction, the primary rule provides for a denial of the duplicate deduction to the extent it exceeds the taxpayer's dual inclusion income (i.e. income brought into account for tax purposes under the laws of both jurisdictions where the hybrid mismatch arises). Conversely, when Luxembourg is the payer jurisdiction and the primary rule is not applied by the counterparty jurisdiction, a secondary or defensive rule applies in Luxembourg to prevent a deductible payment against non-dual inclusion income[100].

Deductible payments which come within the scope of these rules may include interest payments, royalties, rents and other amounts, such as payments for services that may be set-off against ordinary income.[101]

Example: Tax Treatment of Double Deductions

A company resident in State A ("A-Co") has a subsidiary resident in State B ("B-Co"). B-Co obtained an interest-bearing loan ("IBL") from a bank. While under the domestic tax law of State A, B-Co is considered to be fiscally transparent, under the domestic tax law of State B, B-Co is considered to be opaque. In view of this different classification, B-Co is a hybrid entity.



The interest paid by B-Co to the Bank is deductible in State B given that B-Co is treated as opaque under the domestic tax law of State B. In addition, the same interest payment is deductible in State A where B-Co is treated as transparent from a tax perspective. Therefore, the interest payments to the bank result to a double deduction (DD).

If Luxembourg was State A, the primary rule would result in the non-deductibility of the expenses at the level of A-Co (Article 168*ter* [3] No. 1 a) of the LITL). If Luxembourg was State B and State A would not disallow the deductibility of the expenses at the level of A-Co, B-Co would not be able to claim a deduction of the expenses in accordance with Article 168*ter* (3) No. 1 b) of the LITL.

96. See recital 11 of ATAD 2.
97. See, for example, Final Report on BEPS Action 2, p. 59, No. 155; p. 72, No. 200.
98. See Final Report on BEPS Action 2, p. 31, No. 43.
99. Article 168*ter* (3) No. 1 of the LITL.
100. See Final Report on BEPS Action 2, p. 69, No. 186.
101. See Final Report on BEPS Action 2, p. 69, No. 188.

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No mismatch arises, however, if and to the extent a deduction is set-off against dual inclusion[102]. As the hybrid mismatch rules are generally not intended to be affected by timing differences, payments, expenses or losses should remain deductible to offset dual inclusion income in the current tax period and may be carried forward to offset dual inclusion income in subsequent years[103]. Moreover, when deductions set-off non-dual inclusion income, the tax adjustment should be no more than what is necessary to neutralise the hybrid mismatch and not lead to economic double taxation[104].

C. Deductions Without Inclusions

Where a hybrid mismatch results in a deduction without inclusion, the mismatch should be neutralised as follows:

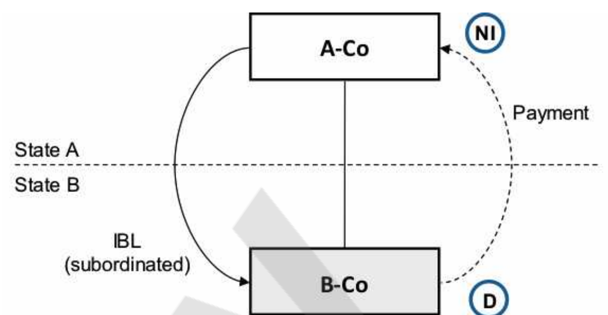
a) the payment is not deductible at the level of the paying taxpayer (primary rule); or

b) where the payment is deductible in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome is included in the taxable income of the payee taxpayer regardless of Article 166 (2*bis*) of the LITL (secondary rule[105]).

The aforementioned rules align the tax treatment of payments made under the arrangement so that a Luxembourg payer is not entitled to claim a deduction unless and to the extent that the payment is treated as ordinary income of the payee. When a Luxembourg taxpayer is the payee, a payment that would otherwise give rise to a deduction without inclusion outcome is to be treated as taxable income.

Example: Tax Treatment of a Deduction Without Inclusion

A company resident in State A ("A-Co") has a 100% participation in a company resident in State B ("B-Co"). A-Co finances B-Co with a subordinated loan ("IBL") that is classified under the laws of State B as a debt instrument. In contrast, under the laws of State A, the loan is classified as an equity interest and the payments under the instrument benefit from an exemption under the domestic participation exemption regime.



Consequently, the payment will be deductible in State B (D), whereas the payment will not be included in the taxable basis of A-Co in State A (NI), resulting in a deduction without inclusion outcome (D/NI).

If Luxembourg was State B, the primary rule would result in the non-deductibility of the expenses at the level of B-Co (Article 168*ter* [3] No. 2 a) of the LITL). If Luxembourg was State A and State B would not disallow the deductibility of the expenses at the level of B-Co, the payment under the IBL should be included in the taxable income of A-Co (Article 168*ter* [3] No. 2 b) of the LITL).

With regard to payments under financial instruments made by entities listed in the Appendix to Article 2 of the Parent-Subsidiary Directive to a Luxembourg corporate taxpayer, Article 166 (2*bis*) of the LITL provides that the Luxembourg participation exemption regime only applies if such payment is not deductible at the level of the paying EU subsidiary. Thus, when Article 166 (2*bis*) of the LITL applies, there is no room for the application of Article 168*ter* (3) No. 2 of the LITL.

The Luxembourg legislator chose to exclude the following types of hybrid mismatches from the scope of the secondary rule:

- Payments to a hybrid entity[106];
- Payments to an entity with one or more PEs[107];
- Payments to a disregarded PE[108]; and
- Deemed payments between the head office and a PE[109].

102. See Final Report on BEPS Action 2, p. 71, No. 197.
103. Article 168*ter* (3) No. 1 of the LITL; see Final Report on BEPS Action 2, p. 72, No. 201.
104. See Final Report on BEPS Action 2, p. 72, No. 200.
105. Article 168*ter* (3) No. 2 of the LITL.
106. Article 168*ter* (1) No. 2 b) of the LITL.
107. Article 168*ter* (1) No. 2 c) of the LITL.
108. Article 168*ter* (1) No. 2 d) of the LITL.
109. Article 168*ter* (1) No. 2 f) of the LITL.

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As long as a deductible payment is included in taxable income in at least one jurisdiction, there is no mismatch for the rule to apply to. Likewise, when CFC rules apply and a payment is fully attributed to the (indirect) parent company of the group where it is subject to standard taxation, the payment should be considered as being included for the purposes of Article 168*ter* (3) No. 2 of the LITL.[110]

The Luxembourg legislator further opted for a carve-out regarding hybrid regulatory capital which is meant to avoid unintended outcomes in the interaction between the hybrid financial instrument rule and the loss-absorbing capacity requirements imposed on banks[111]. This carve-out applies until 31 December 2022 to hybrid mismatches resulting from a payment of interest under a financial instrument to an associated enterprise if the following conditions are met:

– the financial instrument has conversion, bail-in or write down features;

– the financial instrument has been issued with the sole purpose of satisfyin loss-absorbing capacity requirements applicable to the banking sector and the financial instrument is recognised as such in the taxpayer's loss-absorbing capacity requirements;

– the financial instrument has been issued:

- in connection with financial instruments with conversion, bail-in or write down features at the level of a parent undertaking;
- at a level necessary to satisfy applicable loss absorbing capacity requirements,
- not as part of a structured arrangement; and

– the overall net deduction for the consolidated group under the arrangement does not exceed the amount that it would have been had the taxpayer issued such financial instrument directly to the market[112].

D. Imported hybrid mismatches

Imported hybrid mismatches shift the effect of a hybrid mismatch between parties in third countries (be it intragroup or structured arrangements) into the jurisdiction of EU Member States through the use of a non-hybrid instrument.[113]

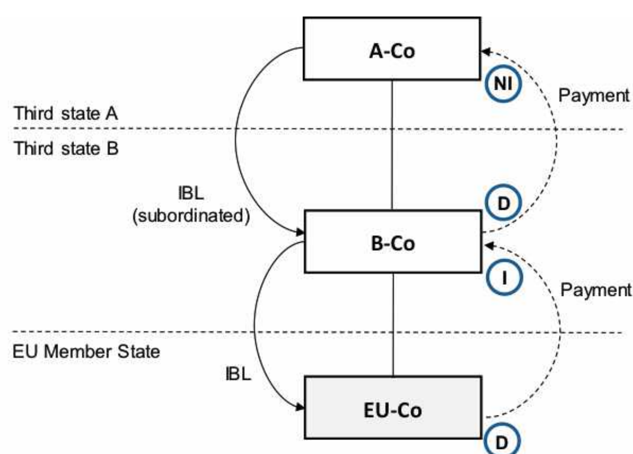
To counter such imported mismatches, Article 168*ter* (3) No. 3 of the LITL provides that payments are not deductible for tax purposes to the extent that such payments directly or indirectly fund deductible expenditures giving rise to a hybrid mismatch through a transaction or a series of transactions between associated enterprises or entered into as part of a structured arrangement.

The imported hybrid mismatch rule may disallow deductions for a broad range of payments, such as interest, royalties, rents and payments for services if the income from such payments is set-off, directly or indirectly, against a deduction that arises under a hybrid mismatch arrangement in third States (including arrangements that give rise to double deduction outcomes).[114]

Example: Imported Deduction without Inclusion

A company resident in third State A ("A-Co") finances its subsidiary resident in third State B ("B-Co") with a subordinated loan ("IBL (subordinated)"). Under the domestic tax law of third State B, the IBL (subordinated) is classified as a debt instrument and related interest expenses are deductible for tax purposes. In contrast, under the domestic tax law of third State A, the IBL (subordinated) is treated as equity and payments received from B-Co are treated as dividends that benefit from a tax exemption in accordance with the participation exemption regime applicable in third State A.

B-Co uses the funds received under the IBL (subordinated) to grant an interest-bearing loan ("IBL") to its subsidiary that is resident in an EU Member State ("EU-Co"). In the EU Member State, the IBL is classified as a debt instrument and related interest expenses are deductible for tax purposes. Likewise, under the domestic tax law of third State B, the IBL is classified as debt instrument and related interest income is included in the taxable income.



110. See Final Report on BEPS Action 2, p. 57, No. 149.
111. See recital 17 of ATAD 2.
112. See Article 168*ter* (3) No. 2 of the LITL.
113. See Final Report on BEPS Action 2, p. 83.
114. See Final Report on BEPS Action 2, p. 83, No. 234.

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In the present example, a hybrid mismatch occurring between A-Co and B-Co is imported to the EU Member State as the tax-deductible payments at the level of EU-Co finance expenditure incurred by B-Co in relation to a hybrid financial instrument.

If Luxembourg was the EU Member State, the imported hybrid mismatch rule would result in the non-deductibility of the payment made by EU-Co to B-Co (Article 168*ter* [3] No. 3 of the LITL).

However, the payment remains deductible to the extent that one of the jurisdictions involved in the transaction (or a series of transactions) has made an equivalent adjustment in respect of such hybrid mismatch. This should generally involve an adjustment in one of the third States concerned.

Example: Neutralised Imported Hybrid Mismatch

On the basis of the previous example, it is assumed that third State B introduced hybrid mismatch rules which entail the non-deductibility of payments made under the hybrid financial instrument granted by A-Co to B-Co.

As a consequence, there would be no deduction without inclusion outcome as a result of the hybrid mismatch arising between third State A and third State B which may trigger the application of the imported hybrid mismatch rule in the EU Member State.

E. Income derived through a disregarded PE

Where a hybrid mismatch involves the income of a disregarded PE that is tax exempt in accordance with a tax treaty concluded between Luxembourg and another EU Member State, the income that would otherwise be attributed to the disregarded PE should be included in the taxable income of the Luxembourg taxpayer[115]. In this case, there would be no deduction without inclusion outcome and the payment should remain deductible at the level of the payer[116].

This provision is limited to disregarded PEs in an EU context and should not apply when the income of a PE is tax exempt in accordance with a tax treaty concluded between Luxembourg and a third country[117].

While ATAD 2 provides that any adjustment that are required thereunder should in principle not affect the allocation of taxing rights between jurisdictions laid down under a tax treaty, the inclusion of the income of a foreign PE that would otherwise be tax exempt under a tax treaty may amount to illegitimate tax treaty override. In practice, however, there should be no cases of disregarded PEs in an EU context.

F. Tax residency mismatches

When a Luxembourg corporate taxpayer is deemed to be resident for tax purposes in one or more foreign jurisdictions, payments, expenses or losses that are also deductible in the other jurisdiction(s) should not be tax deductible in Luxembourg to the extent that such other jurisdiction(s) allows such payments, expenses or losses to be set-off against income that is not dual-inclusion income[118].

However, tax residency mismatches should generally not occur in Luxembourg as tax treaties concluded by Luxembourg eliminate cases of dual residence through the application of the tiebreaker rule[119].

G. Hybrid transfers

Where a hybrid transfer gives rise to a deduction without inclusion outcome, the general rules set out in section 2.2.3. for neutralising mismatches from payments under a hybrid financial instrument should apply.

Article 168*ter* (1) No. 2 a) of the LITL provides a specific carve-out for financial traders according to which a payment which represents the underlying return on a transferred financial instrument does not give rise to a hybrid mismatch (resulting from a payment under a financial instrument) when the payment is made by a financial trader under an on-market hybrid transfer. However, this carve-out is subject to the condition that the payer jurisdiction requires the financial trader to include the entire amount received in relation to the transferred financial instrument as income. In this regard, on-market hybrid transfer refers to any hybrid transfer that is entered into by a financial trader in the ordinary course of business and not as part of a structured arrangement[120].

Where a hybrid transfer is designed to produce a relief for tax withheld at source on a payment derived from a financial instrument, with the relief being available for more than one of the parties involved, the benefit of such relief is limited in proportion to the net taxable income regarding such payment. The non-deductible part of the

115. Article 168*ter* (3) No. 4 of the LITL.
116. See recital 29 of ATAD 2.
117. See Article 9 (4) No. 5 of ATAD.
118. Article 168*ter* (4) of the LITL.
119. Article 4 (3) of the OECD Model (2014 version).
120. Article 168*ter* (1) No. 14 of the LITL.

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foreign withholding tax would further not be deductible for tax purposes under Article 13 2) of the LITL[121].

IV. COOPERATION DUTIES OF THE TAXPAYER

According to Article 168*ter* (6) of the LITL, the taxpayer has the burden of proof that the hybrid mismatch rules are not applicable in a given case. This means that taxpayers have, upon request, to provide the tax authorities with comprehensive, objective and verifiable information and documentation, such as a statement of the issuer of a financial instrument, a foreign tax return, a tax certificate or any other document issued by foreign tax authorities in order to demonstrate that the hybrid mismatch rules provided under Article 168*ter* (3)–(5) of the LITL are not applicable.

Although Article 168*ter* (6) of the LITL does not require taxpayers to proactively provide comprehensive evidence when filing the corporate tax returns (but only upon request), the potentially severe consequences of Article 168*ter* of the LITL will pressure taxpayers to review their existing investments and include a hybrid mismatch analysis in each and every future tax analysis. After all, taxpayer cannot wait to find out about a potential hybrid mismatch situation upon an investigation by the Luxembourg tax authorities that may span over several years.

V. CONCLUSION

Since 1 January 2020, the comprehensive hybrid mismatch rules provided under ATAD 2 have been transposed into Luxembourg tax law. In addition, a reverse hybrid mismatch rule will apply as from tax year 2022. ATAD 2 virtually covers any possible situation that may give rise to mismatch outcomes. However, many of these situations hardly ever occur in practice and others will disappear as a result of the new rules.

Overall, Luxembourg made the right choices, adopting all available implementation options which limit the scope of the new rules for the benefit of Luxembourg taxpayers and avoid unintended collateral damage for the Luxembourg fund industry. The opinion of the Luxembourg State Council further provides useful clarifications regarding the interpretation of the new rules.

The hybrid mismatch rules are characterised by an extreme complexity which requires a good understanding of the overall investment structure and the foreign tax treatment of payments, entities, financial instruments, etc. Given that the burden of proof regarding the non-application of the hybrid mismatch rules is on the taxpayer, a hybrid mismatch analysis will necessarily become an integral part of each and every tax analysis albeit relevant information only needs to be produced to the Luxembourg tax authorities upon request. After all, taxpayers cannot take the risk to implement an investment that falls within the scope of the hybrid mismatch rules.

With regard to existing investments, it would be wise for taxpayers to make sure that either the hybrid mismatch rules do not apply, or to implement, where necessary, structure alignments with a view to mitigate adverse tax consequences. Ultimately, the complexity of the hybrid mismatch rules may also be an opportunity to manage their impact in practice.

121. Article 168*ter* (5) of the LITL.§ 204 AO.

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