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ATOZ TAX ALERT

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The end of hybrid mismatches: EU Finance Ministers reach an agreement on ATAD 2

Structures involving double non-taxation are being restricted. The EU will extend restrictions applying in case of mismatch situations from pure EU-to-EU hybrids to EU-to-non-EU hybrids. Yesterday's ECOFIN[1] meeting agreed on an **EU Directive proposal amending the Anti-Tax-Avoidance-Directive** ("ATAD")[2] as regards **hybrid mismatches with third countries** ("ATAD 2"). While the ATAD already included measures dealing with hybrid mismatches in an EU context, the ATAD 2 proposal replaces these rules and extends their scope to transactions involving third countries. The EU Council is expected to adopt ATAD 2 once the European Parliament has given its opinion.

Hybrid mismatches covered by ATAD 2

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

- Hybrid mismatches that result from **payments under a financial instrument**;
- Hybrid mismatches that are a consequence of differences in the **allocation of payments made to a hybrid entity or permanent establishment (PE)**, including situations where payments made to a disregarded PE are not taxed at the level of the head office;
- 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;
- **Double deduction** outcomes resulting from **payments made by a hybrid entity or PE**.

ATAD 2 offers EU Member States certain options when it comes to the implementation of the measures into their internal law.

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[1] Economic and Financial Affairs Council

[2] Directive (EU) 2016/1164

Where ATAD 2 should have no impact

It is interesting to note that the guidance provided in the ATAD 2 **clarifies a number of issues** in relation to the scope and the application of the rules on hybrid mismatches.

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

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

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

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

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

Last but not least, ATAD 2 provides for a carve-out from the rules when it comes to **hybrid regulatory capital**. This is of particular importance for the banking sector which has to comply with certain solvency criteria. However, this carve-out should be limited in time until 31 December 2022. With regard to **financial traders**, a delimited approach is followed in line with that followed by the OECD.

Timing aspects

EU Member States will have until 31 December 2019 to transpose ATAD 2 into national laws and regulations which need to **enter into force as from 1 January 2020** (apart from the measure on reverse hybrid mismatches which has to be implemented by 1 January 2022). This is a longer timeline than originally foreseen for the rules on hybrid mismatches in an EU context (i.e. ATAD required an implementation by 31 December 2018).

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Conclusion

ATAD 2 **replaces the rules on hybrid mismatches provided in the ATAD and postpones their implementation** into the domestic tax laws of EU Member States by one year.

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

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

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

Can we help? Do you have further questions?

KEITH O'DONNELL
Managing Partner
International & Corporate Tax
keith.odonnell@atoz.lu
T + 352 26 940 257

OLIVER R. HOOR
Partner
International & Corporate Tax
oliver.hoor@atoz.lu
T + 352 26 940 646

SAMANTHA SCHMITZ-MERLE
Director
Knowledge
samantha.merle@atoz.lu
T + 352 26 940 235