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European Union tax alert

ECOFIN agrees to extend rules on hybrid mismatches: Anti-Tax Avoidance Directive 2

On 21 February 2017, the EU Economic and Financial Affairs Council (ECOFIN) reached political agreement on the terms of a draft directive to expand the scope of the EU's Anti-Tax Avoidance Directive (ATAD) in respect of countering hybrid mismatches.

The draft directive (ATAD 2) is the latest of a number of measures to strengthen rules against corporate tax avoidance in the EU. It would fully implement the recommendations made in the G20/OECD BEPS report on action 2 ("Neutralising the Effects of Hybrid Mismatch Arrangements") across the EU. It also includes provisions in respect of hybrids involving permanent establishments (PEs) in line with the OECD's discussion draft on BEPS action 2 ("Branch Mismatch Structures") issued in August 2016.

The ATAD 2 extends the EU's hybrid mismatch rules to cover mismatches between EU member states and non-member states. It also introduces new provisions on the use of hybrids involving PEs, dual residents, imported mismatches and reverse hybrids. There is a limited exception in respect of regulatory capital and for financial traders.

Overview of extended hybrid mismatch rules

The ATAD sets out straightforward anti-hybrid rules for situations where there are differences in the legal characterization of payments or entities between EU member states such that a "double deduction" or "deduction without inclusion" outcome arises.

ATAD 2 introduces more detailed rules that address a wider range of arrangements and broadens the scope to cover mismatches arising both (i) between EU member states; and (ii) between an EU member state and countries outside of the EU.

EU member states will be required to implement rules in their domestic legislation that address the following types of arrangements:

- A payment under a financial instrument that gives rise to a deduction without inclusion outcome (including "hybrid transfers" where the underlying return on the transferred financial instrument is treated as derived simultaneously by more than one of the parties to that arrangement (e.g. certain repo transactions));
- A payment to a hybrid entity that gives rise to a deduction without inclusion and this mismatch arises due to differences in the allocation of the payment under the laws of the jurisdiction where the hybrid entity is established and the jurisdiction of any person with a participation in the hybrid entity;
- A payment to an entity with one or more PEs that gives rise to a deduction without inclusion;
- A payment that gives rise to a deduction without inclusion as a result of a payment to a disregarded PE;
- A payment by a hybrid entity 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;
- A deemed payment between the head office and the 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;
- A double deduction outcome arises;
- Reverse hybrid mismatches (excluding collective investment vehicles); and
- Dual resident mismatches.

In line with the BEPS recommendations, the provisions will neutralize arrangements through the disallowance of a deduction, inclusion of income or a limitation of tax relief at source. The primary rule is that a tax deduction should be denied, and the linked secondary rule is that income should be taxed, e.g. where a non-EU country does not deny a deduction.

It is possible for groups to have a hybrid mismatch arrangement between two countries that do not introduce hybrid rules, and then transfer the benefit to a third country using an arrangement that does not give rise to a hybrid mismatch. Imported mismatch rules in the third country would neutralize the benefit of the hybrid mismatch to which it is indirectly a party (to the extent that none of the other jurisdictions involved in the transactions has made an equivalent adjustment).

EU member states have the option of providing an exclusion for intragroup instruments that have been issued with the sole purpose of meeting regulatory capital requirements and not for the purposes of avoiding tax. This exclusion is permitted until 31 December 2022, and the European Commission will be asked to present a report assessing its consequences.

Member states should use the applicable explanations and examples in the BEPS action 2 report to aid interpretation of the directive (to the extent it is consistent with the provisions of the directive and EU law).

Process and timetable

Under the European treaties, direct taxation is the sole preserve of individual EU member states, subject to compliance with the treaties. EU measures on taxation require the unanimous agreement of all member states. ECOFIN will adopt the directive once the European Parliament has given its formal opinion.

Member states then will be obliged to adopt the domestic legislation necessary to comply with the draft directive by 31 December 2019 (with an extension until 31 December 2021 for the reverse hybrids provisions). The draft directive is limited to general provisions and it will be left to member states to shape the specific elements of those rules in a way that fits best their corporate tax systems.

The provisions will apply in each member state no later than 1 January 2020 (except for the measures to address reverse hybrids, which will apply no later than 1 January 2022).

Member states may adopt the measures at an earlier date if they wish to do so.

Comments

The draft directive builds on the ATAD that was agreed in July 2016 and included limited anti-hybrid rules along with other EU-wide anti-abuse measures. The member states agreed that implementing the ATAD speedily meant that only limited anti-hybrid rules could be included, but they asked the European Commission to formulate more detailed rules. Further to proposals made by the Commission in October 2016, it has taken less than four months to agree to the further measures needed to fully implement the BEPS recommendation through the new ATAD 2 draft directive. ATAD 2 aims to ensure that hybrid mismatches of all types cannot be used to avoid tax in the EU, even where the arrangements involve third countries.

Limited optional exceptions were agreed for regulatory capital and for financial traders, which, to the extent implemented by member states, will be welcomed by the financial services sector.

The ATAD 2 provisions will have a longer timeline for implementation. The rules generally will apply from 1 January 2020, a year later than the original ATAD hybrid measures. The exception is the reverse hybrid mismatch rules, which are delayed until 1 January 2022 (although in some cases, reverse hybrids may be countered through the imported mismatch rules).

Contacts

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