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Amendments to the Anti-Tax Avoidance Directive (ATAD)

Yesterday, 27 April 2017, the European Parliament voted in favour of the proposed amendments to the Anti-Tax Avoidance Directive (ATAD) in order to neutralise hybrid mismatch structures involving non-EU countries (ATAD II). The proposed amendments will now be submitted for formal adoption at a next EU Economic and Financial Affairs Council (Ecofin) meeting.

The ATAD was formally adopted 12 July 2016 and lays down rules in the areas of: (i) interest deduction, (ii) exit taxation, (iii) a general anti-abuse rule (GAAR), (iv) controlled foreign companies (CFC), and (v) hybrid mismatches.

The framework to tackle hybrid mismatch arrangements in the ATAD was limited to hybrid mismatches between Member States only. The new amendments to the ATAD provide for minimum standards for hybrid mismatches involving non-EU countries as well. Furthermore, whereas the ATAD only covered situations of double deduction or deduction without inclusion resulting from hybrid entity mismatches or hybrid financial instrument mismatches, ATAD II expands the scope of the hybrid mismatches framework to a wide variety of other mismatches.

In this *GT Alert*, we will briefly discuss the main aspects of ATAD II.

Main Aspects of ATAD II

Scope of ATAD II

The ATAD includes rules on hybrid mismatches between Member States. ATAD II broadens the scope to mismatches with non-EU countries that apply to all taxpayers subject to corporate tax in one or more Member States, including permanent establishments (PEs) in one or more Member States of entities that are tax resident in a non-EU country. Furthermore, the scope of the hybrid mismatches framework is expanded to a wide variety of other mismatches as described below.

ATAD II only covers mismatches that arise between head office and PE, between two PEs of the same entity, between associated enterprises, and those resulting from structured arrangements. The term "associated" is defined in ATAD II and generally covers direct and indirect interests of 25 percent or more (for certain types of mismatches the percentage is increased to 50 percent).

Furthermore, ATAD II only neutralizes mismatches resulting in mismatch outcomes (*i.e.*, double deductions and deductions without inclusion). To neutralize these mismatches, Member States are either required to: (i) deny the deduction of payments, expenses or losses; (ii) include payments as taxable income, or (iii) deny relief from double taxation.

Types of Hybrid Mismatches and Treatment of Mismatch Outcome

- *Hybrid Entity Mismatches (already covered by the ATAD)*

Hybrid entity mismatches may occur when an entity is qualified as being non-transparent for tax purposes under the laws of one jurisdiction and tax-transparent under the laws of another jurisdiction.

To the extent that such hybrid mismatch results in double deduction, the deduction shall be denied in the investor Member State or, as a secondary rule, in the payer Member State.

To the extent that such hybrid mismatch results in a deduction without inclusion, the deduction shall be denied in the payer Member State or, as a secondary rule, the amount of the payment shall be included as taxable income in the payee Member State.

- *Hybrid Financial Instrument Mismatches (already covered by the ATAD)*

Hybrid financial instrument mismatches may occur when the characterization of a financial instrument, or the payments made under it, differ between two jurisdictions.

To the extent that such hybrid mismatch results in double deduction, the deduction shall be denied in the investor Member State or, as a secondary rule, in the payer Member State.

To the extent that such hybrid mismatch results in a deduction without inclusion, the deduction shall be denied in the payer Member State or, as a secondary rule, the amount of the payment shall be included as taxable income in the payee Member State.

- *Hybrid Transfers Mismatches*

Hybrid transfers mismatches may occur in any arrangement involving the transfer of financial instruments where differences in the tax treatment of that arrangement result in the same financial instrument being treated as held by more than one taxpayer.

To the extent that a hybrid transfer is designed to produce a relief for tax withheld at source on a payment derived from a transferred financial instrument to more than one of the parties involved, the Member State of the taxpayer shall limit the benefit of such relief in proportion to the net taxable income regarding such payment.

- *Hybrid PE Mismatches*

Hybrid PE mismatches may occur where an EU taxpayer has a PE in another Member State or in a third country and the two jurisdictions treat the PE differently.

The Member State in which the taxpayer is tax resident shall require income inclusion to the extent a hybrid mismatch involves disregarded PE income not subject to tax in that Member State, unless a double tax treaty concluded with a third country requires exemption of the income.

- *Imported Mismatches*

Imported mismatches may occur in any arrangement in which the effect of a hybrid mismatch between parties in non-EU countries is shifted into the jurisdiction of a Member State through the use of a non-hybrid instrument, thereby undermining the effectiveness of the rules that neutralize hybrid mismatches.

To neutralize imported mismatches, ATAD II includes a provision disallowing the deduction of a payment under a non-hybrid instrument if the corresponding income from that payment is set-off, directly or indirectly, against a deduction that arises under a hybrid mismatch arrangement giving rise to a double deduction or a deduction without inclusion between third countries.

- *Dual Resident Mismatches*

Dual resident mismatches may occur when a payment made by a dual resident taxpayer is deducted under the laws of both jurisdictions where the taxpayer is resident.

To the extent dual (or more) tax residency results in double deduction, the taxpayer Member State shall deny deduction insofar as the duplicate deduction is offset in the other jurisdiction against non-dual-inclusion income. If both jurisdictions are Member States, the Member State where the taxpayer is not deemed to be a resident according to the double taxation treaty between the two Member States shall deny the deduction.

- *Reverse Hybrid Mismatches*

Reverse hybrid mismatches may occur when an entity is incorporated or established in a Member State which qualifies the entity as transparent, whereas the jurisdiction of one or more associated non-resident entities that hold a direct or indirect interest of 50 percent or more qualifies the entity as non-transparent.

A hybrid entity shall be regarded as a resident of the Member State of incorporation or establishment and taxed on its income to the extent this income is not otherwise taxed. This rule shall not apply to collective investment vehicles.

Exceptions

In specific situations, payments made by financial traders do not give rise to hybrid mismatches, provided that certain requirements are met. Furthermore, ATAD II allows Members States to exclude mandatory income inclusion in the case of certain hybrid mismatch situations. In addition, ATAD II includes an exemption with respect to the banking sector that provides for Member States to, for a limited time, be able to exclude from the scope of ATAD II intra-group regulatory capital that has been issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements and not for the purposes of avoiding tax.

Conclusion

Ecofin is expected to formally adopt ATAD II at a forthcoming Ecofin-meeting. Member States will have to implement all these measures by 31 December 2019 and they need to be applied as of 1 January 2020. However, the rules regarding the so-called reverse hybrids will only have to be implemented by 31 December 2021 and they need to be applied as of 1 January 2022.

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