

## Luxembourg Newsflash

22 February 2017

### ECOFIN agreed on amendments to the ATAD regarding hybrid mismatches with third countries

On 21 February 2017, the Economic and Financial Affairs Council of the European Union agreed on a new proposal for a Council Directive (**ATAD II**) amending the so-called Anti-Tax Avoidance Directive (Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market - **ATAD**). The main changes consist in the extension of the scope of the provisions on hybrid mismatches from European Union (**EU**) Member States (**MS**) to third countries in order to align the ATAD with the rules recommended by the Organization for Economic Co-operation and Development (**OECD**) in the 2015 final report on Action 2 of the Base Erosion and Profit Shifting (**BEPS**) project.

#### From a restricted EU scope under the ATAD...

The ATAD introduced certain measures to be adopted by all EU MS in various fields including hybrid mismatches. According to the ATAD, in case of a hybrid mismatch, the legal characterization given to the hybrid instrument or entity would follow the MS of the income.

The hybrid mismatches rules under the ATAD only cover intra-EU situations involving i) hybrid entities or EU permanent establishment of entities resident for tax purposes in third countries and ii) hybrid instruments that give rise to:

- a double deduction (**DD**), or
- a deduction and a non-inclusion (**D/NI**) of the same payment.

Therefore, taxpayers within the EU and engaged in cross-border structures involving third countries do not fall under the provisions of the ATAD.

For more details on the ATAD, [please refer to our newsflash entitled 'Recent BEPS related legislation/guidance impacting Luxembourg', of 1 July 2016](#) available on our website, section Publications/Newsflash.

## ...to an extended scope under ATAD II

To provide rules consistent with and not less effective than the rules recommended by the OECD's report on Action 2 of the BEPS project, the ATAD II geographically broadens the scope of the ATAD to third countries and covers:

- **hybrid transfers mismatches** which may occur in any arrangements 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;
- **hybrid permanent establishment mismatches** which may occur where an EU taxpayer has a permanent establishment (**PE**) in another Member State or in a third country and the two jurisdictions treat the PE differently;
- **imported mismatches** which may occur in any arrangements under which the deduction resulted from a hybrid mismatch arrangement that was produced in a different jurisdiction, is imported to a third jurisdiction and set off the income in that third jurisdiction;
- **dual resident mismatches** which occur where the payer is a dual resident and makes a payment that is deductible under the law of both jurisdictions and that DD outcome results in a hybrid mismatch; and
- **reverse hybrids** which may be defined as any hybrid entity that is treated as a taxable entity by residence state of the investor and as transparent under the state of establishment of the entity and for which D/NI outcome may arise. Any non-resident entities holding at least 50% of the voting rights, capital interests or rights to a share of profit in a hybrid entity located within the EU may fall under the ATAD II to the extent the country of residence of the shareholder considers this hybrid entity as a taxable person. It has to be noted that collective investment vehicles (**CIV**) are excluded. CIV means an investment fund or vehicle that is widely held, holds a diversified portfolio of securities and is subject to investor-protector regulation.

The outcomes have also been extended to cover:

- **non-taxation without inclusion (NT/NI)** which may occur where a permanent establishment is disregarded under the law of the branch jurisdiction which leads to a non-taxation of the income and a non-inclusion in the other jurisdiction; and
- **double tax relief at source (DTR)** which may occur where an instrument or a payment has a different characterisation in the two jurisdictions. However, the ATAD II provides that a payment under a financial instrument should fall under this outcome qualification to the extent the tax relief is solely due to the tax status of the payee or the instrument is subject to a special regime.

## Practical guidance

Outcome	ATAD and ATAD II for EU situations	ATAD II for third countries situations
<b>DD (hybrid entity and financial instrument)</b>	MS to deny deduction if MS is investor jurisdiction	MS to deny deduction unless already denied by 3 <sup>rd</sup> country
<b>D/NI (hybrid entity and financial instrument)</b>	MS to deny deduction if MS is payer jurisdiction	<ul style="list-style-type: none"> <li>▪ MS to deny deduction if MS is payer jurisdiction</li> <li>▪ MS to include payment in taxable basis if 3<sup>rd</sup> country is the payer jurisdiction unless it already denies deduction</li> </ul>
<b>NT/NI (permanent establishment)</b>	MS of the taxpayer to include income attributed to PE in tax base	MS to include income attributed to 3 <sup>rd</sup> country PE in tax base unless the income is exempt under the DTT concluded between the MS and the 3 <sup>rd</sup> country
<b>DD (imported mismatch)</b>	N/A	MS to deny deduction unless already denied by 3 <sup>rd</sup> country
<b>D/NI (imported mismatches)</b>	N/A	MS to deny deduction unless already denied by 3 <sup>rd</sup> country
<b>DTR (hybrid transfer)</b>	MS to limit the benefit of relied in proportion to net taxable income	MS to limit the benefit of relied in proportion to net taxable income unless already denied in 3 <sup>rd</sup> country
<b>Dual resident mismatches</b>	N/A	MS to deny deduction in case 3 <sup>rd</sup> country allows the duplicate deduction to be set off against income that is not dual-inclusion income
<b>Reverse hybrid</b>	MS to tax income from the entity to the extent it is not taxed in the other MS	MS to tax income from the entity to the extent it is not taxed in the 3 <sup>rd</sup> country

## Exceptions

Certain exceptions are however foreseen:

- at the option of each MS, the scope of the hybrid mismatch provisions is limited for hybrid regulatory capital of banks until 31 December 2022; and
- certain payments made by financial traders representing the underlying return on a transferred financial instrument under an on-market hybrid transfer may be excluded under certain conditions.

## Date of implementation

MS are required to implement the ATAD II by 31 December 2019 and apply the provisions thereof by 1 January 2020. As an exception, the provisions regarding reverse hybrids must be implemented by 31 December 2021 and applied by 1 January 2022.

## Our view

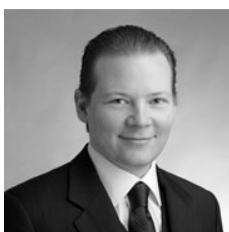
The agreed ATAD II mainly follows its previous draft and completes the ATAD with the final conclusions of Action 2 of the BEPS project. Once adopted by the EU, it will need to be implemented by Luxembourg within the above-mentioned delays. In this context, the Luxembourg government stressed out the importance of a level-playing field.

Meanwhile, it is recommendable to review cross border investments in order to assess and, if necessary, monitor any risks arising from the future application of the ATAD II. Special attention needs to be paid to cross border structures involving US investors (*i.e.* US MNEs or Fund promoters) in which *e.g.* Luxembourg corporations or corporations in other jurisdictions have been treated *e.g.* as either partnerships or disregarded entities or foreign partnerships or disregarded entities which are treated for US tax purposes as corporations. The qualification of these entities as well as certain instruments used in these structures may directly fall under the scope of the ATAD II.

For further guidance, please do not hesitate to contact our Tax team: Eric Fort, Alain Goebel, Thierry Lesage and Jan Neugebauer or your usual contact within the team.



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