European Parliament

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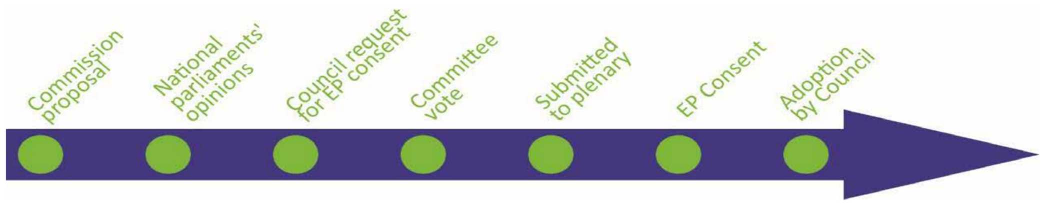
Hybrid mismatches with third countries

Hybrid mismatch is a situation where a cross-border activity is treated differently for tax purposes by the countries involved, resulting in favourable tax treatment. Hybrid mismatches are used as aggressive tax planning structures, which in turn trigger policy reactions to neutralise their tax effects.

When adopting the Anti-Tax Avoidance Directive in July 2016, the Council requested that the Commission put forward a proposal on hybrid mismatches involving third countries. The amendment proposed by the Commission on 25 October broadens the provisions of the directive accordingly. It seeks to neutralise mismatches by obliging Member States to deny the deduction of payments by taxpayers or by requiring taxpayers to include a payment or a profit in their taxable income.

The Parliament's opinion was prepared by the Economic and Monetary Affairs Committee. As this is a tax measure, Parliament is only consulted. The proposal was adopted by the Council on 29 May 2017.

Proposal for a Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries	
COM(2016) 687, 25.10.2016, 2016/0339(CNS), Consultation procedure – Parliament adopts only a non-binding opinion	
Committee responsible:	Economic and Monetary Affairs (ECON)
Rapporteur:	Olle Ludvigsson (S&D, Sweden)
Shadow rapporteurs:	Sirpa Pietikäinen (EPP, Finland) Pirkko Ruohonen-Lerner (ECR, Finland) Nils Torvalds (ALDE, Finland) Matt Carthy (GUE/NGL, Ireland) Eva Joly (Greens/EFA, France)
Procedure completed.	Council Directive (EU) 2017/952 of 29 May 2017 OJ L 144, 7.6.2017, p. 1.



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Introduction

Hybrid mismatches are situations that can arise when taxing corporate businesses with activities in more than one country. The issue is how to determine the corporate tax base in cross-border activities and how the countries involved may treat a given situation differently for tax purposes. Hybrid mismatches have been identified as structures of aggressive tax planning that require the adoption of provisions to neutralise their tax effects.

Context

Corporate tax challenges in the global and digital environment are well documented, especially when it comes to taxing multinational enterprises (MNE) doing business globally while tax jurisdictions cover situations linked with individual countries.[1]

The challenges of delineating the tax base of cross-border business are not new. However, a more problematic situation is developing because of the widespread use of aggressive tax planning techniques – including hybrid mismatch arrangements – by large multinationals aiming to reduce their tax base. In short, the potential for mismatch arrangements arises when two countries consider a certain taxable event differently and in such a way that it results in favourable tax treatment.

Providing a definition for these arrangements is not always straightforward since they refer both to the structure and its consequences, which depends on the tax rules applicable in the situation considered, i.e. national and international tax rules and their interpretation. The word 'hybrid' describes the fact that a certain situation is not treated in the same manner by two tax jurisdictions involved in the cross border business. It refers to the classification or the characterisation of an arrangement triggering a particular tax treatment. This is typically the case when, for instance, income received by a parent company from a subsidiary is not considered taxable income in the country of the parent company, whereas the related expense of the subsidiary is deductible in the country of the subsidiary. This unilateral treatment results in an inconsistent outcome creating a mismatch.

Existing situation

BEPS action plan

MNEs' corporate tax avoidance and aggressive tax planning practices result in base erosion and profit shifting. The OECD/G20 base erosion and profit shifting (BEPS) action plan was completed by the finalisation of the 15 BEPS final reports in autumn 2015; these were endorsed by G20 leaders in November 2015. They cover three main goals: creating more consistency in national tax rules that affect cross-border activities; strengthening substance requirements in existing international standards; and improving certainty and

1 Applying either source state taxation or resident state taxation (for an explanation see Philippe Malherbe, *Elements of international income taxation*, Bruylant, available in English and French).

transparency. The actions are the result of a consensus and were designed to be implemented in domestic law and practice, as well as through changes to the provisions of the relevant treaties.

The reports deal with common forms of BEPS, setting out measures for eliminating or neutralising the effects of such practices. Hybrid mismatches are covered by BEPS Action 2, whose objective is to 'neutralise the effects of hybrid mismatch arrangements'. The recommendations do not provide for a minimum standard and discussions are still under way in the OECD Forum.[2] The action delivers tools to neutralise the effects when both countries have introduced measures based on the recommendations, and when that is not the case, by either a 'primary response' or a 'secondary response'.

EU actions addressing corporate tax avoidance and aggressive tax planning

On 17 June 2015, the European Commission presented an action plan on a fair and efficient corporate tax system for the European Union. It was the second set of measures (the first being the March 2015 tax transparency package) to combat tax evasion and aggressive tax planning. The action plan considers the following main principles: the need to re-establish the link between taxation and the place where economic activity happens, and the need to ensure that Member States can value corporate activity in their jurisdiction correctly.

The anti-tax-avoidance package, presented by the European Commission on 28 January 2016, reflects the 2015 adoption of the BEPS final reports. It is part of the European Commission's agenda for fairer, simpler and more effective corporate taxation in the EU. The package contains proposals on concrete measures to prevent aggressive tax planning (the Anti-Tax-Avoidance Directive), to boost tax transparency and to create a level playing field for all businesses in the EU.

2 For ongoing work relating to this action, see this dedicated webpage. The latest discussion paper was released on 22 August 2016 and relates to 'branch mismatch structures'.

The July 2016 Anti-Tax-Avoidance Directive

The Anti-Tax-Avoidance Directive proposal targets schemes where corporate taxpayers operating businesses in several countries take advantage of disparities and loopholes to reduce their tax bills. The proposal sets legally binding minimum standards for six practices, including hybrid mismatches,[3] on which specific subject the Commission proposal was not endorsed by the Council as proposed. Council Directive 2016/1164 (the Anti-Tax-Avoidance Directive – ATAD) was adopted on 12 July 2016. It covers the most common forms of hybrid mismatch arrangements within the European Union, namely hybrid entity and hybrid financial instrument mismatches,[4] but hybrid mismatches with third countries are beyond its scope. Member States must transpose the measures set out in the directive into domestic law by 31 December 2018, so that they apply no later than 1 January 2019 (with a limited number of exceptions).

The October 2016 corporate tax reform package

The corporate tax reform package of 25 October 2016 is aimed at setting up a single corporate tax system for the single market and improving the tools used to prevent double taxation, in order to provide for a more modern and fairer tax system for business. The package consists of a 'chapeau' communication on 'building a fair, competitive and stable corporate tax system for the EU', four new proposals, and their respective impact assessments. Two of the proposals relate to the re-launch of the common consolidated corporate tax base (CCCTB), namely: the proposal on a common corporate tax base (CCTB) and the proposal on a common consolidated corporate tax base (CCCTB). The other two are a proposal on double taxation dispute resolution mechanisms and a proposal amending the June 2016 Anti-Tax Avoidance Directive in order to extend the rules to hybrid mismatches involving non-EU countries.

Parliament's starting position

In its resolution on the ATAD, adopted on 8 June 2016, the European Parliament proposed a number of amendments to the Commission proposal. In particular it proposed the addition of a definition of hybrid mismatches as 'a situation between a taxpayer in one Member State and an associated enterprise, as defined under the applicable corporate tax system, in another Member State or a third country where the following outcome is attributable to differences in the legal characterisation of a financial instrument or entity', and to limit the proposed article to hybrid mismatches within the EU while adding a specific provision for hybrid

3 Article 10 of the proposal reads: 'Where two Member States give a different legal characterisation to the same taxpayer (hybrid entity), including its permanent establishments in one or more Member State, and this leads to either a situation where a deduction of the same payment, expenses or losses occurs both in the Member State in which the payment has its source, the expenses are incurred or the losses are suffered and in another Member State or a situation where there is a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion of the same payment in the other Member State, the legal characterisation given to the hybrid entity by the Member State in which the payment has its source, the expenses are incurred or the losses are suffered shall be followed by the other Member State'.

4 Article 9 of the adopted directive reads: 'Hybrid mismatches 1. To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source. 2. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment'. The proposal includes provisions addressing mismatches within the EU.

mismatches involving a third country.[5] The resolution also included a proposed amendment relating to penalties in cases of infringements of the ATAD provisions.[6]

Council starting position

When adopting the ATAD, the Council requested that the Commission 'put forward a proposal by October 2016 on hybrid mismatches involving third countries in order to provide for rules consistent with and no less effective than the rules recommended by the OECD BEPS report on Action 2'.

The Commission's proposal responds to this request. This starting position was further expressed in the Council conclusions of 6 December 2016 on the communication from the Commission of 25 October 2016 on building a fair, competitive and stable corporate tax system for the EU, introducing the corporate tax reform package.

5 Respectively amendments to Article 2(1) and Article 10 and insertion of a new Article 10a. The latter read as follows: 'Where a hybrid mismatch between a Member State and a third country results in a double deduction, the Member State shall deny the deduction of such a payment, unless the third country has already done so. Where a hybrid mismatch between a Member State and a third country results in a deduction without inclusion, the Member State shall deny the deduction or non-inclusion of such a payment, as appropriate, unless the third country has already done so.'

6 Amendment proposed Article 10 e) which reads 'Member States shall lay down the rules on penalties applicable to infringements of national provisions adopted pursuant to this Directive and shall take all measures necessary to ensure that they are implemented. The penalties provided for shall be effective, proportionate and dissuasive. Member States shall, without delay, notify the Commission of those rules and of those measures and shall notify it of any subsequent amendment affecting them'.

Proposal

Preparation of the proposal

In July 2016 a Council statement on hybrid mismatches requested that the Commission propose an amendment to the ATAD. As a result, the proposal for a directive amending the directive on rules against tax-avoidance practices was presented by the European Commission in its corporate tax reform package of 25 October 2016.[7] It covers hybrid mismatch arrangements where at least one of the parties involved is a corporate taxpayer in a Member State while the others are tax residents in third countries. It supplements the ATAD provisions regarding hybrid mismatches between Member States with provisions for third countries.

The preparation of the proposal built on the work done in the framework of the BEPS action plan and of the action reports, and, more specifically, on consultations and assessments carried out for the ATAD, as explained in the Commission staff working document accompanying the proposal (SWD(2016) 345 final).

Action 2 of the BEPS action plan is entitled 'Neutralising the effects of hybrid mismatch arrangements', and is relevant to the fact that EU Member States treat the same income or entities differently for tax purposes, which can lead to double non taxation.

The changes the proposal would bring

The proposal provides an EU answer to a problem that Member States cannot solve individually, since there is a need for consistency in the approach so as to ensure a level playing field in the single market. Similarly, the effectiveness of global tax policy measures is conditional upon the coordinated and effective implementation of measures neutralising hybrid mismatches within the EU and globally. Independent actions would increase fragmentation in the single market and result in the persistence of mismatches.

The proposal addresses hybrid mismatches involving third countries and those involving permanent establishments, both intra-EU and involving a third country, hybrid transfers, imported mismatches and dual resident mismatches. It tackles mismatches relating to the legal characterisation of an entity or a financial instrument and to differing treatment of a commercial presence (as a permanent establishment). Put simply, the proposal for the ATAD II Directive contains anti-abuse rules that concern hybrid mismatch arrangements involving third countries.

The proposal provides for amendments to Article 2, adding a definition of 'associated enterprises', 'hybrid mismatch', 'consolidated group for financial accounting purposes' and 'structured arrangement'; Article 4 on an interest limitation rule in relation to consolidated statements; and Article 9 on hybrid mismatches

7 The package consists of a communication on Building a fair, competitive and stable corporate tax system for the EU, two proposals related to the re-launch of the Common (Consolidated) Corporate Tax Base (CCTB and CCCTB), a proposal for a directive on double taxation dispute resolution mechanisms in the European Union, and a proposal for a directive amending the Anti-Tax-Avoidance Directive (ATAD) of 12 July 2016.

with the addition of a new Article 9a on 'tax residency mismatches'. The implementation date is set at 31 December 2018.

The now broader definition of hybrid mismatches covers the following situations:

> hybrid entity mismatches (already included in the ATAD);
> hybrid financial instrument mismatches (already included in the ATAD);
> hybrid transfers (added);
> hybrid permanent establishment mismatches (added);
> imported mismatches (this requires a payment by a taxpayer from a Member State to a third country and the involvement of at least one other third country) (added); and
> resident mismatches (when a taxpayer is resident in both a Member State and a third country (added).

The proposal provides for measures to neutralise the mismatch arising from double deductions (Article 9(1) and (4)), deductions without inclusion (Article 9(2) and (5)), non-taxation without inclusion (Article 9(3)), and double tax relief at source (Article 9(6)), by denying deduction, including income or limiting tax relief at source.

Views

Advisory committees

The European Economic and Social Committee (EESC) adopted its opinion (rapporteur: Mihai Ivaşcu (Various interests – GR III / Romania)) in December 2016.

In addition to welcoming the proposal and noting that it would be effective only if similar rules were implemented in third countries, the opinion also stresses the need to 'look at the causes of hybrid mismatch arrangements, close the potential loopholes and prevent aggressive tax planning, rather than just seeking to obtain tax revenue'. Moreover, the committee recommends looking into the possibility of introducing and applying sanctions to taxpayers benefiting from hybrid mismatch arrangements, in order to prevent and/or tackle these practices. Finally it would like to see a 'broad report describing the status of the implementation of the directive' in the EU, in order to draw a picture of hybrid mismatch arrangements, both in the EU and globally.

National parliaments

The subsidiarity deadline for national parliaments to submit comments on the proposals was 3 January 2017, and the parliaments of eight countries completed the scrutiny process. Reasoned opinions were issued by the parliaments in Sweden and the Netherlands (submitting two opinions, one from each chamber), while the Bundesrat in Germany called for changes to the proposal under political dialogue. The Portuguese assembly adopted a written opinion that did not raise any subsidiarity issues.

Stakeholders' views[8]

A number of stakeholders presented their positions on hybrid mismatches in relation to the ATAD proposal. Some additional comments on the topic, relating more or less closely to the current proposal, were prepared in connection with ongoing work in the framework of BEPS Action 2. Other consultancies published specific presentations or statements.[9]

The 'Confédération fiscale européenne' (CFE) issued an opinion statement on the 2016 proposal for an Anti-Tax Avoidance Directive[10] and another on the OECD discussion draft on branch mismatch structures (BEPS Action 2). Insurance Europe also issued a specific position paper noting that virtually all major European

8 This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'EP supporting analysis'.
9 Mayer Brown, Deloitte
10 The opinion is based on the approach taken by the Commission in its proposal, not on the article as adopted by the Council. The opinion stresses in particular the difference between the Commission approach and the BEPS Action 2 approach, stressing that 'the approach proposed by the Commission deviates substantially from the OECD Recommendations, resulting in discoordination with third states that legislate in accordance with the OECD, with adverse consequences for European businesses that also operate outside of the EU'.

insurers issue hybrid regulatory capital in the market and calling for consistency with the OECD BEPS recommendations, whilst giving support to the inclusion of a carve-out for unrelated parties in the EU rules as well. Article 2 (b) point 9 of the Commission proposal states that a hybrid mismatch can only exist 'between a taxpayer and an associated enterprise or a structured arrangement between parties in different tax jurisdictions'.

Legislative process

Based on Article 115 of the Treaty on the Functioning of the European Union, adoption of the directive requires unanimity in the Council, following consultation of the European Parliament (special legislative procedure).

In the Council, the proposal was presented together with the corporate tax reform package, to the preparatory body responsible (the Working Party on Tax Questions – Direct Taxation) and subsequently to the Economic and Financial Affairs Council on the 8 November 2016. The Council adopted conclusions on 6 December 2016 concerning the Commission communication of 25 October 2016 on building a fair, competitive and stable corporate tax system for the EU. Building on the examination of the proposal as presented to the Council on the same day, the preparatory bodies prepared a Presidency compromise on the proposal, published on 17 February 2017. This was agreed by the Council on 21 February 2017. The compromise sought to reconcile the differences in Member State positions, namely regarding the implementation date set at 1 January 2019 in the proposal and exemptions for the financial sector.

The agreed position amends the proposal on the two above-mentioned issues. It restricts the exemption to the banking sector (hybrid regulatory capital) to a limited period, the consequences of which will be assessed by the Commission. It also proposes a delimited approach for financial traders rather than retaining a specific exemption. It extends implementation by one year to 1 January 2020 in general (with a specific provision).

In the European Parliament, the proposal was assigned to the Economic and Monetary Affairs Committee (ECON – rapporteur Olle Ludvigsson, S&D, Sweden). The committees for opinion – Trade (INTA) and Internal Market and Consumer Protection (IMCO) – decided not to give opinions. A draft report was prepared for consideration by the ECON committee at the end of March. Parliament's opinion was adopted in plenary on 27 April 2017. The report recommended to the Council to add a definition of the notion of 'disregarded permanent establishment', and questioned exemptions for the banking sector (introduced by the Council) while stressing the need for support to be given developing countries in tackling such effects.

On 29 May 2017, the Council adopted the directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (ATAD II), following its 21 February position and the opinion of the Parliament adopted on 27 April. The transposition date for Member States is set at 31 December 2019, for the application of the provisions of the directive as of 1 January 2020. A derogation to this is set for the reverse hybrid entity rule (requiring taxation of income to the extent not taxed, Article 9a of the directive) with transposition and implementation deadlines set two years later. The directive broadens the scope of the ATAD by encompassing in the hybrid mismatch definition situations of double deduction, deduction without inclusion, imported mismatch, disregarded PE income and hybrid transfer (Article 9), reverse hybrid mismatches (article 9a), and tax residency mismatches (Article 9b).

References

EP supporting analysis

Anti-tax avoidance directive, EU Legislation in progress briefing, EPRS, July 2016

Other sources

EP Legislative Observatory, Procedure file on a directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, 2016/0339(CNS).

Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

European Commission, Corporate tax reform package

European Commission, Study on structures of aggressive tax planning and indicators, Taxation papers No 61 -2015, report part of the anti-tax avoidance package, January 2016

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