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PROPOSAL

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
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To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
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Subject:	Proposal for a COUNCIL DIRECTIVE amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

Delegations will find attached document COM(2016) 687 final.

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2016/0339 (CNS)

Proposal for a

COUNCIL DIRECTIVE

amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

{SWD(2016) 345 final}

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EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

• Reasons for and objectives of the proposal

Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of corporate taxpayers in the EU. Therefore, it is necessary to lay down rules against this kind of tax base erosion.

The hybrid mismatch rules in the Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market[1] (hereinafter: the Anti-Tax Avoidance Directive) address the most widespread forms of hybrid mismatches, but only within the EU. Article 9 of the Anti-Tax Avoidance Directive targets hybrid mismatches arising from differences in the legal characterisation of an entity or a financial instrument between a taxpayer in a Member State and an associated enterprise in another Member State or from a structured arrangement between parties in Member States.

However, taxpayers in the EU engaged in cross-border structures involving third countries also take advantage of hybrid mismatches to reduce their overall tax liability in the EU. Therefore, it is widely recognised that hybrid mismatches involving third countries should be countered as well.

Furthermore, there are other types of mismatches, such as hybrid permanent establishment mismatches, hybrid transfers, so-called imported mismatches and dual resident mismatches, which are not addressed in Article 9 of the Anti-Tax Avoidance Directive.

As part of the final compromise proposal for the Anti-Tax Avoidance Directive that was agreed on 20 June 2016, the ECOFIN Council issued a statement on hybrid mismatches. In this statement the ECOFIN Council requests the Commission "to put forward by October 2016 a proposal 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, with a view to reaching an agreement by the end of 2016."

This Directive lays down rules against hybrid mismatches involving third countries. Furthermore, this Directive addresses hybrid mismatches involving permanent establishments, both in their intra-EU and third-country dimension, hybrid transfers, imported mismatches and dual resident mismatches.

• Consistency with existing policy provisions in the policy area

This Directive draws upon the recommendations of the OECD Base Erosion and Profit Shifting (BEPS) report on Action item 2 'Neutralising the Effects of Hybrid Mismatch Arrangements'. Most Member States have committed to implement those recommendations. The OECD BEPS report provides for a comprehensive framework on hybrid mismatches and covers hybrid entity mismatches, hybrid financial instrument mismatches, hybrid transfers, imported mismatches and dual resident mismatches. Furthermore, the OECD has published a Public Discussion Draft on Branch Mismatch Structures released on 22 August 2016 covering hybrid permanent establishment mismatches. A coherent and coordinated fashion of

[1] Council Directive (EU) 2016/1164, OJ L 193/1.

transposing the OECD recommendations at EU level should avoid possible distortions, tax obstacles for businesses, new loopholes or mismatches in the internal market.

This Directive is part of a package that also includes the re-launch of the Proposal for a Common Consolidated Corporate Tax Base (CCCTB) and a proposal on a Common Corporate Tax Base (CCTB). The rules on hybrid mismatches in the CCCTB and CCTB are consistent with the rules in this Directive.

The Code of Conduct Group on Business Taxation has agreed on guidance to tackle various kinds of hybrid mismatches. However, considering that Member States cannot be legally bound by guidance, it is still necessary to adopt binding rules to ensure that Member States effectively tackle these mismatches.

This Directive is an amendment to the Anti-Tax Avoidance Directive. It sets out legally binding rules to enable Member States to effectively tackle hybrid mismatch arrangements that are not dealt with in the Anti-Tax Avoidance Directive.

The text lays down principle-based rules and leaves the details of their implementation to Member States, on the understanding that they are better placed to shape the precise elements of the rules in a way that best fits their corporate tax systems. This Directive has the same personal scope as the Anti-Tax Avoidance Directive and thus aims to capture all taxpayers which are subject to corporate tax in a Member State.

2. LEGAL BASIS, SUBSIDIARITY AND PROPORTIONALITY

• Legal basis

Direct tax legislation falls within the ambit of Article 115 of the Treaty on the Functioning of the EU (TFEU). The clause stipulates that legal measures of approximation under that article shall be vested the legal form of a Directive.

• Subsidiarity (for non-exclusive competence)

This proposal complies with the principle of subsidiarity. The nature of the subject requires a common initiative across the internal market.

Considering that a key objective of this Directive is to improve the resilience of the internal market against tax avoidance risks arising from the manipulation of hybrid mismatches, it is clear that this cannot sufficiently be achieved by Member States acting individually, in a non-concerted mode. A mismatch in taxation is the result of the interaction of at least two tax systems, which implies that there is a cross-border dimension inherent in such a mismatch. Given that national corporate tax systems are disparate, independent action by Member States would only replicate the existing fragmentation of the internal market in direct taxation and allow mismatches to persist. The effects of mismatches can only be tackled through remedial measures at Union level. In addition, given that hybrid mismatches distort the functioning of the internal market, the application of common principles for resolving them would enhance the coherence of the internal market.

Moreover, a comprehensive framework of rules against hybrid mismatch arrangements at the level of the EU would add value compared to what a multitude of national rules can attain. An

EU initiative minimises the risk of persisting loopholes or double taxation, which risk a patchwork of national rules addressing hybrid mismatches could entail.

Such an approach is therefore in accordance with the principle of subsidiarity, as set out in Article 5 of the Treaty on the European Union.

- **Proportionality**

The envisaged measures do not go beyond ensuring the necessary level of protection for the internal market. In accordance with the principle of proportionality, the proposed rules do not go further than what is necessary for achieving their objective. The Directive does not therefore prescribe full harmonisation but only the protection which is required to safeguard Member States' corporate tax systems. They are limited to rectifying instances of double deduction, deduction in one state without inclusion in the tax base of the other state or non-taxation of income in one state without inclusion of that income in the other state. Thus, the Directive ensures the essential degree of coordination within the Union for the purpose of materialising its aims. The rules do not interfere with the national frameworks which qualify entities or payments from a legal point of view. The Directive only aims to achieve the essential with the aim to mitigate the harmful tax effects of hybrid mismatches in the internal market. In this light, the proposal does not go beyond what is necessary to achieve its objectives and is therefore compliant with the principle of proportionality.

- **Choice of the instrument**

The proposal is for a Directive, which is the only available instrument under the legal base of Article 115 TFEU.

3. RESULTS OF EX-POST EVALUATIONS, STAKEHOLDER CONSULTATIONS AND IMPACT ASSESSMENTS

- **Stakeholder consultations**

Most Member States are members of the OECD and participated in lengthy and detailed discussions on the anti-BEPS Actions, including Action item 2 on neutralising hybrid mismatch arrangements, between 2013 and 2015. The OECD organised extensive public consultations with stakeholders on each of the anti-BEPS Actions.

The elements of this proposal for a Directive have been discussed with Member States' delegations at the Working Party IV meeting of 26 July 2016. Furthermore, the elements of this proposal for a Directive were presented in broad terms and discussed with business and non-governmental organisations' representatives at the meeting of the Platform for Tax Good Governance on 16 September 2016.

- **Collection and use of expertise**

Elements of this Directive draw upon the OECD Report on Neutralising the Effects of Hybrid Mismatch Arrangements which was part of the OECD/G20 BEPS Project.

- **Impact assessment**

As part of the BEPS package the OECD has published the report on Action item 2 in November 2015. OECD/G20 members are committed to the outcomes of the BEPS Project and to its consistent implementation. Many Member States, in their capacity as OECD Members, have undertaken to transpose the output of the BEPS Project into their national laws, and to do so urgently. As for the other outcomes of the BEPS Project it is critical to make fast progress in coordinating the implementation in the EU of rules on hybrid mismatches involving third countries. It is necessary to avoid that the functioning of the internal market is compromised either by unilateral measures adopted by some Member States (whether OECD members or not) acting on their own, or by a lack of action by other Member States.

To provide a qualitative analysis a separate Staff Working Document (SWD) accompanying this Directive gives an overview of existing findings on hybrid mismatch arrangements based on recent studies by the OECD and the European Commission. The SWD highlights the most common identified mechanisms which are linked to hybrid mismatch arrangements. Furthermore, the SWD addresses the objectives and features of this Directive.

Therefore, no impact assessment was carried out for this proposal on the following grounds: there is a strong link to the OECD BEPS work; the SWD supplies a significant analysis of existing findings; and stakeholders were involved in consultations on the technical elements of the proposed rules at a previous stage. In this context it should be noted that no impact assessment was carried out on the Anti-Tax Avoidance Directive to which this proposal is an amendmentIn addition, there is an urgent current demand in the form of a Council Statement accompanying the Anti-Tax Avoidance Directive by the Member States for a Directive on this matter to be put forward by October 2016.

4. BUDGETARY IMPLICATIONS

This proposal for a Directive does not have any budgetary implications for the EU.

5. OTHER ELEMENTS

- **Detailed explanation of the specific provisions of the proposal**

The recommendations in the OECD report on neutralising hybrid mismatch arrangements (hereinafter: the OECD report) take the form of rules which neutralise the effect of a hybrid mismatch by ensuring that a payment is subject to tax at least once. The hybrid mismatch rules in the Anti-Tax Avoidance Directive are based on the OECD approach in the sense that they neutralise the effect of a hybrid mismatch. This proposal is based on the same approach. Like the Anti-Tax Avoidance Directive this proposal applies to all taxpayers which are subject to corporate tax in a Member State. The aim is to capture all hybrid mismatch arrangements where at least one of the parties involved is a corporate taxpayer in a Member State.

This Directive is not intended to affect the general features of the tax system of a jurisdiction but only mismatches as a result of conflicting tax rules between two or more jurisdictions. Therefore, this Directive does not address situations in which little or no tax has been paid due to a low tax rate or the tax system of a jurisdiction.

The hybrid mismatch rules are applicable only in case of a mismatch between a taxpayer and an associated enterprise or in case of a structured arrangement between the parties involved. The definition of an associated enterprise for the purpose of the hybrid mismatch rules is based on the definition of the so-called 'control group' to which the recommendations in the OECD report apply.

For reasons of legal certainty it should be underlined that this Directive refers to a deduction from the taxable base or an inclusion in the taxable base of an enterprise.

- Hybrid entity mismatches

The term 'entity' refers to any type of legal organisation in which a business may be carried on. An entity can be transparent or non-transparent for tax purposes. If an entity is transparent for tax purposes, for example in case of a partnership, the entity itself is not subject to tax, but the proportionate share of the items of income, gain and expenditure derived and incurred by the partnership is allocated to the partners as taxable income. On the other hand a non-transparent entity, for example a company, is subject to tax on its income. A permanent establishment can be part of an entity but is not regarded as a separate entity itself.

A hybrid entity mismatch occurs if an entity is treated as transparent for tax purposes by one jurisdiction and as non-transparent by another jurisdiction. This may lead to a double deduction of the same payment, expenses or losses or to a deduction of a payment without a corresponding inclusion of that payment.

Hybrid entity mismatch leading to a double deduction

A double deduction means that the same payment is deductible from the taxable base in more than one jurisdiction. If an entity is treated as non-transparent for tax purposes in the jurisdiction in which it was originally formed or created, payment, expenses or losses of the entity may be deductible from the taxable base of the entity. If the same entity is treated as transparent in the jurisdiction of the holder of the equity interest in the entity, those payments, expenses or losses may be deductible from the taxable base of the holder of the equity interest in that jurisdiction as well, leading to a double deduction within the meaning of Article 2, paragraph 9, subparagraph a.

However, income of the hybrid entity might be included as taxable income in more than one jurisdiction as well. To take into account this so-called dual inclusion of income the proposal aims to neutralise a double deduction only to the extent that the same payment, expenses or losses deducted in two jurisdictions exceed the amount of income that can be attributed to the same hybrid entity and that is included in both jurisdictions.

Based on the Anti-Tax Avoidance Directive in case of a hybrid entity mismatch between two Member States leading to a double deduction, a deduction should only be given in the Member State where such payment has its source.

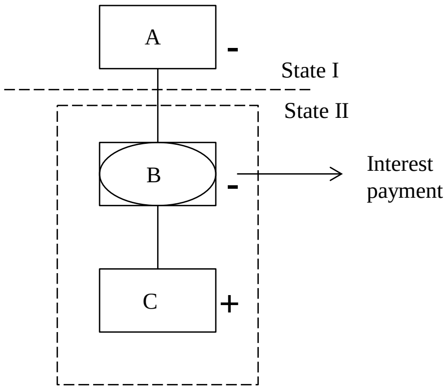
In case of a hybrid entity mismatch between a Member State and a third country, based on Article 9, paragraph 1, second subparagraph, the Member State concerned should deny the deduction of the payment, expenses or losses irrespective of whether the payment has its source in the Member State or in the third country, unless the third country has already done so.

Example 1

A, B and C are associated enterprises.
Hybrid entity B is non-transparent in State II but transparent for State I.
B pays interest to a third party.
Interest payment is deducted both by A Co and by hybrid entity B.
The payment by B is set-off against C Co's income under a group tax regime in State II.

If State I is a MS and State II is a 3rd state,
State I (the MS) should deny the deduction of the interest payment.
If State I is a 3rd state and State II is a MS,
State II (the MS) should deny the deduction of the interest payment.

There can only be a double deduction to the extent that the payment exceeds income from the same source. So, if B has an income of 4 and makes a payment of 10, the double deduction amounts to 6.



Hybrid entity mismatch leading to a deduction without inclusion

A deduction without inclusion means a deduction of a payment from the taxable base in one jurisdiction without a corresponding inclusion of that payment in the taxable base of a taxpayer in another jurisdiction.

For example: if an entity is treated as non-transparent in the jurisdiction in which it is formed or created, it may deduct from its taxable base payments paid to the holder of the equity interest in that entity. If nevertheless the entity is treated as transparent by the jurisdiction in which the holder of the equity interest is a resident, the payments will not be recognised and thus not included in the taxable income of the holder of the equity interest, leading to a deduction without an inclusion within the meaning of Article 2, paragraph 9, subparagraph b.

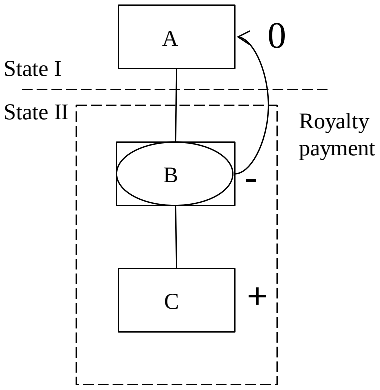
Dual inclusion of income should also be taken into account when neutralising a deduction without inclusion outcome.

Based on the Anti-Tax Avoidance Directive in case of a hybrid entity mismatch between two Member States leading to a deduction without an inclusion, the Member State of the payer should deny the deduction of the payment.

Example 2
A, B and C are associated enterprises.
Hybrid entity B is non-transparent in State II but transparent for State I.
Royalty payment from B to A is deducted by hybrid entity B,
but not included by A Co.
The payment by B is set-off against C Co's income under a group tax regime in State II.

If State I is a MS and State II is a 3rd state,
State I (the MS) should require A Co to include the royalty payment in its income.
If State I is a 3rd state and State II is a MS,
State II (the MS) should deny the deduction of the royalty payment.

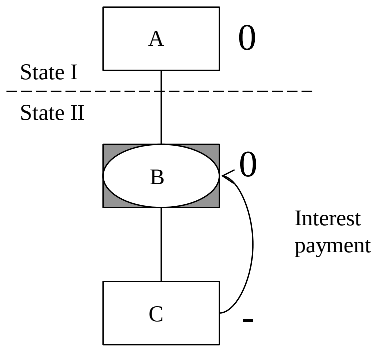
There can only be a double deduction to the extent that the payment exceeds income from the same source. So, if B has an income of 4 and makes a payment of 10, the double deduction amounts to 6.



Or: if an entity is treated as transparent for tax purposes in the jurisdiction in which it was originally formed or created, a payment to that entity will not be taxed there. If nevertheless the holder of the equity interest in that entity is a resident of another jurisdiction and that other jurisdiction treats the entity as non-transparent[2], the payment will neither be taxed in that other jurisdiction. Assuming that the payment had been deducted from the taxable base by the payer, this might also be a situation of deduction without inclusion within the meaning of Article 2, paragraph 9, sub-paragraph b.

Example 3
A, B and C are associated enterprises.
Hybrid entity B is transparent in State II but non-transparent for State I (reverse hybrid entity).
Interest payment from C Co to B is deducted by C Co,
but neither included by reverse hybrid entity B nor by A Co.

If State I is a MS and State II is a 3rd state,
State I (the MS) should require A Co include the interest payment in its income.
If State I is a 3rd state and State II is a MS,
State II (the MS) should deny the deduction of the interest payment by C Co.



In case of a hybrid entity mismatch resulting in a deduction without inclusion between a Member State and a third country, it should be established first which is the jurisdiction of the payer. If the jurisdiction of the payer is a Member State, that Member State should deny the deduction of the payment from the taxable base to the extent of the mismatch on the basis of Article 9, paragraph 2 (i). If the jurisdiction of the payer is a third country, the Member State concerned should provide for a rule that requires the taxpayer to include the payment in the taxable base to the extent of the mismatch on the basis of Article 9, paragraph 2 (ii).

[2] An entity which is treated as transparent in the jurisdiction in which it was originally formed or created and as non-transparent by another jurisdiction is called a reverse hybrid entity.

In addition to the previous example a hybrid entity mismatch resulting in a deduction without inclusion within the meaning of Article 2, paragraph 9, sub-paragraph b, might also occur in case the hybrid entity is neither located in the Member State nor in the jurisdiction of the associated enterprise.

Example 4

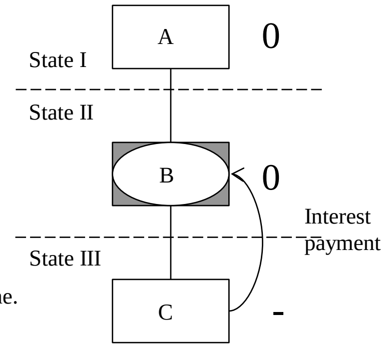
A, B and C are associated enterprises.

Hybrid entity B is transparent in State II and for State III, but non-transparent for State I (reverse hybrid entity).

Interest payment from C Co to B is deducted by C Co,
but neither included by reverse hybrid entity B nor by A Co.

A Co is (also) an associated enterprise of C Co.
There is a mismatch between State I and State III with respect to an entity in another state: Reverse HE B in State II

If State I is a MS and State III is a 3rd state,
State I (the MS) should require A Co to include the interest payment in its income.
If State I is a 3rd state and State III is a MS,
State III (the MS) should deny the deduction of the interest payment by C Co.



• Hybrid financial instrument mismatches

A hybrid financial instrument mismatch occurs if the tax treatment of a financial instrument differs between two jurisdictions. In case of a hybrid financial instrument mismatch there can be a deduction of a payment from the taxable base of the payer but no inclusion of that payment in the taxable base of the recipient, leading to a deduction without an inclusion within the meaning of Article 2, paragraph 9, subparagraph b.

Based on the Anti-Tax Avoidance Directive in case of a hybrid financial instrument mismatch between two Member States leading to a deduction without an inclusion, the Member State of the payer should deny the deduction of the payment.

A hybrid financial instrument mismatch between a Member State and a third country should be addressed depending on the jurisdiction of the payer. If the jurisdiction of the payer is a Member State, that Member State should deny the deduction of the payment from the taxable base to the extent of the mismatch on the basis of Article 9, paragraph 2 (i). If the jurisdiction of the payer is a third country, the Member State concerned should require the payment to be included in the taxable base to the extent of the mismatch on the basis of Article 9, paragraph 2 (ii).

• Hybrid transfers

A hybrid transfer is an arrangement to transfer a financial instrument where the laws of two jurisdictions differ on whether the transferor or the transferee has got the ownership of the payments on the underlying asset. The hybrid transfer rules recommended in the OECD report are particularly targeted at sale and re-purchase (repo) and securities lending transactions. Hybrid transfers are typically designed in financial centres and derive from complex structures. It is not intended to impede these structures as such but only to address the tax consequences where these structures are aimed to benefit from a mismatch situation.

A hybrid transfer may lead to a deduction without inclusion within the meaning of Article 2, paragraph 9, last subparagraph (i), if one jurisdiction treats a payment connected with the underlying return on the transferred instrument as a deductible expense, while the other jurisdiction treats the same amount as a (tax exempt) return on the underlying asset. The underlying return is the income related to and derived from the transferred instrument. In that case Article 9, paragraph 2, should apply to this payment. These hybrid mismatch rules should not apply if the underlying return on the transferred instrument is included in the taxable income of one the parties involved as in that case they will be left in the same tax position as if the transaction had not been entered into.

A hybrid transfer may also exploit differences between a Member State and a third country in attributing income from a financial asset with the effect that the same payment is treated as derived simultaneously by different taxpayers resident in different jurisdictions. In those cases both taxpayers may claim withholding tax credits on the payment as described in Article 2, paragraph 9, last subparagraph (ii). Based on Article 9, paragraph 6, this should be tackled by limiting the amount of the credit in proportion to the taxpayer's net income under the arrangement.

- Hybrid permanent establishment mismatches

A hybrid permanent establishment mismatch between two jurisdictions occurs where the business activities in a jurisdiction are treated as being carried on through a permanent establishment by one jurisdiction, while those activities are not treated as being carried on through a permanent establishment by another jurisdiction.

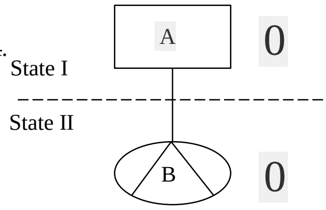
Hybrid permanent establishment mismatch leading to non-taxation without inclusion

A hybrid permanent establishment mismatch may lead to non-taxation without inclusion when a taxpayer carries on business activities in another jurisdiction and this jurisdiction does not treat these activities as being carried on through a permanent establishment while the jurisdiction in which the taxpayer is a resident, treats these activities as being carried on through a permanent establishment in the other jurisdiction. As a result the profits from these business activities are not taxed where they are carried on whereas the jurisdiction in which the taxpayer is a resident provides for an exemption of those profits, leading to non-taxation without inclusion within the meaning of Article 2, paragraph 9, sub-paragraph c.

In case of a hybrid permanent establishment mismatch between more than one Member State resulting in non-taxation without inclusion, the Member State in which the taxpayer is a resident should include (and not exempt) the income attributed to that permanent establishment on the basis of Article 9, paragraph 3, first subparagraph. In case of a hybrid permanent establishment situated in a third country, the Member State concerned, in which the taxpayer is a resident, should also include (and not exempt) the income attributed to that permanent establishment on the basis of Article 9, paragraph 3, second subparagraph.

Example 5
B is recognised as a permanent establishment in State II by State I,
but is not recognised as a PE in State II (reverse hybrid PE).
No taxation in state ~~B~~II, profits attributed to reverse hybrid PE are exempt in state I~~A~~.

If State I is a MS, State I should tax and not exempt the profits attributed to hybrid PE B.



Hybrid permanent establishment mismatch leading to double deduction

A hybrid permanent establishment mismatch may lead to a double deduction within the meaning of Article 2, paragraph 9, subparagraph a, if a payment, expenses or losses are deductible from the taxable base both in the jurisdiction in which the taxpayer is a resident and in the jurisdiction of the hybrid permanent establishment where the payment, expenses or losses can be deducted.

The rules laid down in Article 9, paragraph 1, also apply to a hybrid permanent establishment mismatch leading to a double deduction.

Hybrid permanent establishment mismatch leading to a deduction without inclusion

A hybrid permanent establishment mismatch may lead to a deduction without inclusion within the meaning of Article 2, paragraph 9, subparagraph b, if a payment made by the hybrid permanent establishment to its head office is deducted from the taxable base in the jurisdiction in which the hybrid permanent establishment is situated but is not included in the taxable base in the jurisdiction in which the taxpayer is a resident because the latter jurisdiction does not recognise the permanent establishment.

The rules laid down in Article 9, paragraph 2, also apply to a hybrid permanent establishment mismatch leading to a deduction without an inclusion.

- Imported mismatches

Imported mismatches flow from arrangements involving group members, or structured arrangements in general, which shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of a Member State through the use of a non-hybrid instrument. A mismatch is imported in a Member State if a deductible payment under a non-hybrid instrument is used to fund expenditure under a structured arrangement involving a hybrid mismatch between third countries. This implies a flow of revenue out of the EU which is eventually not taxed. Therefore, it is proposed to include rules that disallow the deduction of a payment if the income from such payment is set-off, directly or indirectly, against a deduction that arises under a hybrid mismatch arrangement giving rise to a double deduction (Article 9, paragraph 4) or a deduction without inclusion (Article 9, paragraph 5) between third countries. The key objective of the imported mismatch rules is to maintain the integrity of the other hybrid mismatch rules by removing any incentive for multinational groups to enter into hybrid mismatch arrangements. It should be noted that the imported mismatch rules do not apply to any payment that is made to a corporate payee in a Member State as Member States should have implemented the other hybrid mismatch rules of this proposal.

An imported mismatch may involve the import of a double deduction:

Example 6

A, B, C, and D are associated enterprises.

D Co is a taxpayer in MS. Interest payment 1 from D Co to C is deducted by D Co.

Interest payment 1 received by C Co is in principle taxable in 3rd Country I,

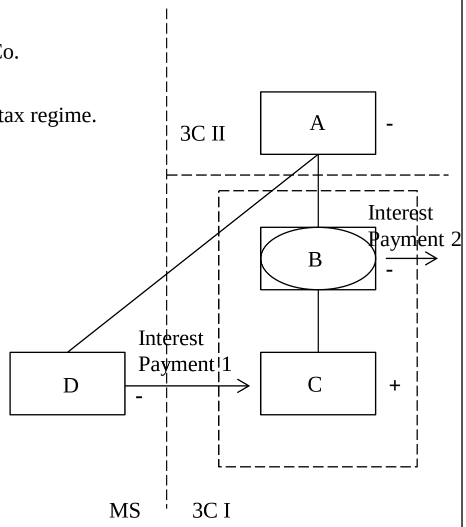
but is set-off against interest payment 2, made by hybrid entity B, a under group tax regime.

Interest payment 2 is also deducted in 3rd Country II by A Co.

So: double deduction of interest payment 2.

Hybrid mismatch between 3rd Country I and 3rd Country II is imported by D Co through the loan connected with interest payment 1.

MS should deny the deduction of interest to the extent of the double deduction.



An important mismatch may also involve the import of a deduction without an inclusion:

Example 7

A, B and C are associated enterprises.

Interest payment by C Co to B Co deducted in MS.

B Co includes interest payment as income,

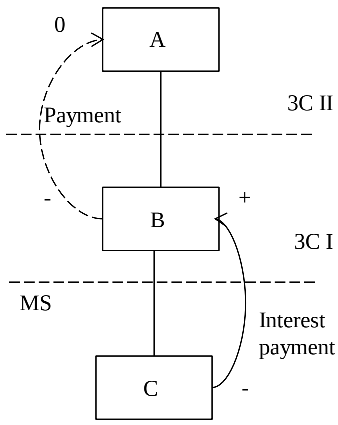
but this interest income is set-off by B Co against a payment to A Co under a PPL.

Payment on the PPL is deducted in 3rd Country I as interest,

but exempt for A Co as dividend. So: deduction without inclusion.

Hybrid mismatch between 3rd Country I and 3rd Country II is imported in MS through the interest payment by C Co.

MS should deny the deduction of interest to the extent of the deduction without inclusion.



- Dual resident mismatches

A dual resident mismatch may result in a double deduction outcome if a payment made by a dual resident taxpayer is deducted under the laws of both jurisdictions where the taxpayer is resident. Therefore, it is proposed in Article 9a that in case of a dual resident mismatch between a Member State and a third country, the Member State should deny the deduction of a payment, but only to the extent that this payment is set-off against an amount that is not treated as income under the laws of the other jurisdiction (i.e. against income that is not "dual inclusion income").

Example 8

A, B and C are associated enterprises.

B Co is a dual resident of State I and State II.

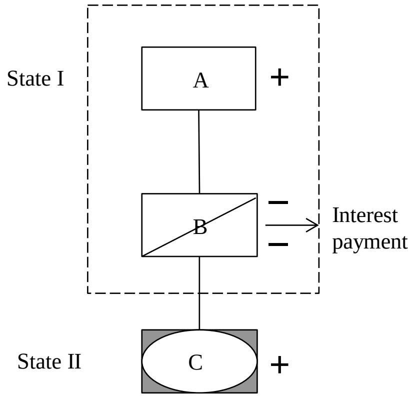
Interest payment by B Co is deducted
and set-off in State I against A Co's income under a group tax regime.

C is a reverse hybrid entity in State II.

Interest payment by B Co is set-off against C's income in State II.

So, a double deduction of the interest payment by B in both State I and State II.

If State I or State II is a MS, this MS should deny the deduction
to the extent of the mismatch.



2016/0339 (CNS)

Proposal for a

COUNCIL DIRECTIVE

amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 115 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Parliament[3],

Having regard to the opinion of the European Economic and Social Committee[4],

Acting in accordance with a special legislative procedure,

Whereas:

(1) It is imperative to restore trust in the fairness of tax systems and allow governments to effectively exercise their tax sovereignty. Therefore, the Organisation for Economic Co-operation and Development (OECD) has issued concrete action recommendations in the context of the initiative against Base Erosion and Profit Shifting (BEPS).

(2) The final reports on the 15 OECD Action Items against BEPS were made public on 5 October 2015. This output was welcomed by the Council in its conclusions of 8 December 2015. The Council conclusions stressed the need to find common, yet flexible, solutions at the Union level consistent with OECD BEPS conclusions.

(3) In response to the need for fairer taxation and in particular to follow up on the OECD BEPS conclusions, the Commission presented its Anti-Tax Avoidance Package on 28 January 2016. Council Directive (EU) 2016/1164[5] on rules against tax avoidance was adopted in the framework of that package.

(4) Directive (EU) 2016/1164 provides for a framework to tackle hybrid mismatch arrangements.

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[3] OJ C , , p. .

[4] OJ C , , p. .

[5] 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 (OJ L 193, 19.7.2016, p. 1).

(5) It is necessary to establish rules that neutralise hybrid mismatches in a comprehesive manner. Considering that Directive (EU) 2016/1164 only covers hybrid mismatch arrangements that arise in the interaction between the corporate tax systems of Member States, the ECOFIN Council issued a statement on 20 June 2016 requesting the Commission to put forward by October 2016 a proposal 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, with a view to reaching an agreement by the end of 2016.

(6) Considering that[, amongst others, it is stated in Recital (13) of Directive (EU) 2016/1164 that] it is critical that further work is undertaken on other hybrid mismatches such as those involving permanent establishments, it is essential that hybrid permanent establishment mismatches are addressed in that Directive as well.

(7) In order to provide for a comprehensive framework consistent with to OECD BEPS report on hybrid mismatch arrangements it is essential that Directive (EU) 2016/1164 would also include rules on hybrid transfers, imported mismatches and dual resident mismatches, in order to prevent taxpayers from exploiting remaining loopholes.

(8) Given that Directive (EU) 2016/1164 includes rules on hybrid mismatches between Member States, it is appropriate to include rules on hybrid mismatches with third countries in that Directive. Consequently, those rules should apply to all taxpayers that are subject to corporate tax in a Member State including permanent establishments of entities resident in third countries. It is necessary to cover all hybrid mismatch arrangements where at least one of the parties involved is a corporate taxpayer in a Member State.

(9) Rules on hybrid mismatches should address mismatch situations which are the result of conflicting tax rules of two (or more) jurisdictions. However, those rules should not affect the general features of the tax system of a jurisdiction.

(10) In order to ensure proportionality it is necessary to address only the cases where there is a substantial risk of avoiding taxation through the use of hybrid mismatches. It is therefore appropriate to cover hybrid mismatch arrangements between the taxpayer and its associated enterprises and hybrid mismatches resulting from a structured arrangement involving a taxpayer.

(11) In order to provide for a sufficiently comprehensive definition of 'associated enterprise' for the purposes of the rules on hybrid mismatches, that definition should also comprise an entity that is part of the same consolidated group for accounting purposes, an enterprise in which the taxpayer has a significant influence in the management and reversely, an enterprise that has a significant influence in the management of the taxpayer.

(12) Mismatches that particularly pertain to the hybridity of entities should be addressed only where one of the associated enterprises has – at a minimum - effective control over the other associated enterprises. Consequently, in those cases, it should be required that an associated enterprise be held by, or hold, the taxpayer or another associated enterprise through a participation in terms of voting rights, capital ownership or entitlement to received profits of 50 percent or more.

(13) It is necessary to address mismatch situations attributable to differences in the legal characterisation of an entity or a financial instrument. It is also necessary to clarify that the legal characterisation relates to the qualification of an entity or financial instrument for tax law purposes. A legal characterisation should also include a qualification of an entity under entity classification election regulations also known as check-the-box rules.

(14) Jurisdictions use different tax accounting periods and have different rules for recognising when items of income or expenditure have been derived or incurred. It is therefore necessary to clarify that as such these timing differences should not be treated as giving rise to mismatches in tax outcomes. However, it is necessary to provide that if a payment is not recognised in the same or overlapping tax period as it is recognised in the Member State of the taxpayer, which in principle leads to a deduction without inclusion, the taxpayer ensure that the payment be recognised within a reasonable period of time in the other jurisdiction.

(15) As hybrid entity mismatches involving third countries may lead to a double deduction or to a deduction without inclusion, it is necessary to lay down rules whereby the Member State concerned either denies the deduction of a payment, expenses or losses or requires the taxpayer to include the payment in its taxable income, as the case may be.

(16) Accordingly, considering that hybrid financial instrument mismatches involving third countries may also lead to a deduction without inclusion, it is necessary to lay down rules whereby the Member State concerned either denies the deduction of the payment or requires the taxpayer to include the payment in its taxable income, depending on the state of the payer.

(17) Hybrid transfers may give rise to a difference in tax treatment if, as a result of a transfer of a financial instrument under a structured arrangement, the underlying return on that instrument is treated as derived simultaneously by more than one of the parties to the arrangement. The underlying return is the income related to and derived from the transferred instrument. This difference in tax treatment may lead to a deduction without inclusion or to a tax credit in two different jurisdictions for the same tax withheld at source. Such mismatches should therefore be eliminated. In case of a deduction without inclusion the same rules should apply as for neutralising a hybrid financial instrument or hybrid entity mismatch leading to a deduction without inclusion. In case of a double tax credit, the Member State concerned should limit the benefit of the tax credit in proportion to the net taxable income with respect to the underlying return.

(18) Hybrid permanent establishment mismatches occur where the business activities in a jurisdiction are treated as being carried on through a permanent establishment by one jurisdiction, while those activities are not treated as being carried on through a permanent establishment by another jurisdiction. Those mismatches may lead to non-taxation without inclusion, a double deduction or a deduction without inclusion, and should therefore be eliminated. In case of non-taxation without inclusion the Member State in which the taxpayer is a resident should include the income that is attributed to the hybrid permanent establishment. In case of a double deduction or a deduction without inclusion, the same rules should apply as for neutralising a hybrid entity

mismatch leading to a double deduction or to a deduction without inclusion respectively.

(19) Imported mismatches shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralise hybrid mismatches. A deductible payment in a Member State can be used to fund expenditure under a structured arrangement involving a hybrid mismatch between third countries. To counter such imported mismatches, it is necessary to include rules that disallow the deduction of a payment 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.

(20) A dual resident mismatch may lead to a double deduction if a payment made by a dual resident taxpayer is deducted under the laws of both jurisdictions where the taxpayer is resident. To address a dual resident mismatch between a Member State and a third country, the Member State should deny the deduction of a payment to the extent that this payment is set-off against an amount that is not treated as income under the laws of the other jurisdiction.

(21) The objective of this Directive is to improve the resilience of the internal market as a whole against hybrid mismatch arrangements. This cannot be sufficiently achieved by the Member States acting individually, given that national corporate tax systems are disparate and that independent action by Member States would only replicate the existing fragmentation of the internal market in direct taxation. It would thus allow inefficiencies and distortions to persist in the interaction of distinct national measures. This would thus result in a lack of coordination. That objective can rather, due to the cross-border nature of hybrid mismatch arrangements and the need to adopt solutions that function for the internal market as a whole, be better achieved at Union level. The Union may therefore adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective. By setting the required level of protection for the internal market, this Directive only aims to achieve the essential degree of coordination within the Union that is necessary to achieve its objectives.

(22) Directive (EU) 2016/1164 should therefore be amended accordingly.

(23) The Commission should evaluate the implementation of this Directive four years after its entry into force and report to the Council thereon. Member States should communicate to the Commission all information necessary for this evaluation,

HAS ADOPTED THIS DIRECTIVE:

Article 1

Directive (EU) 2016/1164 is amended as follows:

(1) Article 2 is amended as follows:

(a) in point (4), the third subparagraph, is replaced by the following:

"For the purposes of Article 9 an associated enterprise also means an entity that is part of the same consolidated group for financial accounting purposes as the taxpayer, an enterprise in which the taxpayer has a significant influence in the management or an enterprise that has a significant influence in the management of the taxpayer. Where the mismatch involves a hybrid entity, the definition of associated enterprise is modified so that the 25 percent requirement is replaced by a 50 percent requirement";

(b) point (9) is replaced by the following:

"(9) 'hybrid mismatch' means a situation between a taxpayer and an associated enterprise or a structured arrangement between parties in different tax jurisdictions where any of the following outcomes is attributable to differences in the legal characterisation of a financial instrument or entity, or in the treatment of a commercial presence as a permanent establishment:

(a) a deduction of the same payment, expenses or losses from the taxable base occurs both in the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered and in the other jurisdiction ('double deduction');

(b) a deduction of a payment from the taxable base in the jurisdiction in which the payment has its source without a corresponding inclusion for tax purposes of the same payment in the other jurisdiction ('deduction without inclusion');

(c) in case of differences in the treatment of a commercial presence as a permanent establishment, non-taxation of income which has its source in a jurisdiction without a corresponding inclusion for tax purposes of the same income in the other jurisdiction ('non-taxation without inclusion').

A hybrid mismatch only arises to the extent that the same payment deducted, expenses incurred or losses suffered in two jurisdictions exceed the amount of income that is included in both jurisdictions and which can be attributed to the same source.

A hybrid mismatch also includes the transfer of a financial instrument under a structured arrangement involving a taxpayer where the underlying return on the transferred financial instrument is treated for tax purposes as derived simultaneously by more than one of the parties to the arrangement, who are resident for tax purposes in different jurisdictions, giving rise to any of the following outcomes:

(a) a deduction of a payment connected with the underlying return without a corresponding inclusion for tax purposes of such payment, unless the underlying return is included in the taxable income of one the parties involved;

(b) a relief for tax withheld at source on a payment derived from the transferred financial instrument to more than one of the parties involved.";

(c) the following points (10) and (11) are added:

"(10) 'consolidated group for financial accounting purposes' means a group consisting of all entities which are fully included in consolidated financial statements drawn up in accordance with the International Financial Reporting Standards or the national financial reporting system of a Member State;

(11) 'structured arrangement' means an arrangement involving a hybrid mismatch where the mismatch is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch.";

(2) Article 4 is amended as follows:

(a) in point (a) of paragraph 5, point (ii) is replaced by the following:

"(ii) all assets and liabilities are valued using the same method as in the consolidated financial statements drawn up in accordance with the International Financial Reporting Standards or the national financial reporting system of a Member State;";

(b) paragraph 8 is replaced by the following:

"8. For the purposes of paragraphs 1 to 7 the taxpayer may be given the right to use consolidated financial statements prepared under other accounting standards than the International Financial Reporting Standards or the national financial reporting system of a Member State.";

(3) Article 9 is replaced by the following:

"Article 9
Hybrid mismatches

1. To the extent that a hybrid mismatch between Member States results in a double deduction of the same payment, expenses or losses, the deduction shall be given only in the Member State where such payment has its source, the expenses are incurred or the losses are suffered.

To the extent that a hybrid mismatch involving a third country results in a double deduction of the same payment, expenses or losses, the Member State concerned shall deny the deduction of such payment, expenses or losses, unless the third country has already done so.

2. To the extent that a hybrid mismatch between Member States results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

To the extent that a hybrid mismatch involving a third country results in a deduction without inclusion:

(i) if the payment has its source in a Member State, that Member State shall deny the deduction, or

(ii) if the payment has its source in a third country, the Member State concerned shall require the taxpayer to include such payment in the taxable base, unless the third country has already denied the deduction or has required that payment to be included.

3. To the extent that a hybrid mismatch between Member States involving a permanent establishment results in non-taxation without inclusion, the Member State in which the taxpayer is resident for tax purposes shall require the taxpayer to include in the taxable base the income attributed to the permanent establishment.

To the extent that a hybrid mismatch involving a permanent establishment situated in a third country results in non-taxation without inclusion, the Member State concerned shall require the taxpayer to include in the taxable base the income attributed to the permanent establishment in the third country.

4. To the extent that a payment by a taxpayer to an associated enterprise in a third country is set off directly or indirectly against a payment, expenses or losses which due to a hybrid mismatch are deductible in two different jurisdictions outside the Union, the Member State of the taxpayer shall deny the deduction of the payment by the taxpayer to an associated enterprise in a third country from the taxable base, unless one of the third countries involved has already denied the deduction of the payment, expenses or losses that would be deductible in two different jurisdictions.

5. To the extent that the corresponding inclusion of a deductible payment by a taxpayer to an associated enterprise in a third country is set off directly or indirectly against a payment which due to a hybrid mismatch is not included by the payee in its taxable base, the Member State of the taxpayer shall deny the deduction of the payment by the taxpayer to an associated enterprise in a third country from the taxable base, unless one of the third countries involved has already denied the deduction of the non-included payment.

6. To the extent that a hybrid mismatch results in 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.

7. For the purposes of paragraphs 1 to 6, 'payer' means the entity or permanent establishment where the payment has its source, the expenses are incurred or the losses are suffered.";

(4) in Chapter II, the following Article 9a is added:

"Article 9a
Tax residency mismatches

To the extent that a payment, expenses or losses of a taxpayer who is resident for tax purposes in both a Member State and a third country, in accordance with the laws of that Member State and that third country, are deductible from the taxable base in both jurisdictions and that payment, those expenses or losses can be set-off in the Member State of the taxpayer against taxable income that is not included in the third country, the Member State of the taxpayer shall deny the deduction of the payment, expenses or losses, unless the third country has already done so.".

Article 2

1. Member States shall adopt and publish, by 31 December 2018 at the latest, the laws, regulations and administrative provisions necessary to comply with this Directive. They shall forthwith communicate to the Commission the text of those provisions.

   They shall apply those provisions from 1 January 2019.

   When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

2. Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

Article 3

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 4

This Directive is addressed to the Member States.

Done at Strasbourg,

For the Council
The President