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LEGISLATIVE ACTS AND OTHER INSTRUMENTS

Subject: COUNCIL DIRECTIVE amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

COUNCIL DIRECTIVE (EU) 2017/...

of ...

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 Parliament¹,

Having regard to the opinion of the European Economic and Social Committee²,

Acting in accordance with a special legislative procedure,

¹ Opinion of 27 April 2017 (not yet published in the Official Journal).

² Opinion of 14 December 2016 (not yet published in the Official Journal).

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 released to the 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 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) 2016/1164¹, concerning rules against tax avoidance, was adopted in the framework of that package.
- (4) Directive (EU) 2016/1164 provides for a framework to tackle hybrid mismatches.

¹ 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 of 19.7.2016, p. 1).

- (5) It is necessary to establish rules that neutralise hybrid mismatches in as comprehensive a manner as possible. Considering that Directive (EU) 2016/1164 only covers hybrid mismatches that arise in the interaction between the corporate tax systems of Member States, the ECOFIN Council issued a statement on 12 July 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 report on Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report ('OECD BEPS report on Action 2'), with a view to reaching an agreement by the end of 2016.
- (6) Directive (EU) 2016/1164 recognises, *inter alia*, that it is critical for further work to be undertaken on other hybrid mismatches such as those involving permanent establishments. In view of that, it is essential that hybrid permanent establishment mismatches be addressed in that Directive as well.
- (7) In order to provide for a framework that is consistent with and no less effective than the OECD BEPS report on Action 2, it is essential that Directive (EU) 2016/1164 also include rules on hybrid transfers, imported mismatches and address the full range of double deduction outcomes, in order to prevent taxpayers from exploiting remaining loopholes.

- (8) Directive (EU) 2016/1164 includes rules on hybrid mismatches between Member States and should thus also include rules on hybrid mismatches with third countries where at least one of the parties involved is a corporate taxpayer or, in the case of reverse hybrids, an entity in a Member State, as well as rules on imported mismatches. Consequently, the rules on hybrid mismatches and tax residency mismatches should apply to all taxpayers that are subject to corporate tax in a Member State including to permanent establishments, or to arrangements treated as permanent establishments, of entities resident in third countries. Rules on reverse hybrid mismatches should apply to all entities that are treated as transparent for tax purposes by a Member State.
- (9) Rules on hybrid mismatches should address mismatch situations which result from double deductions, from conflict in the characterisation of financial instruments, payments and entities, or from the allocation of payments. Since hybrid mismatches could 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 appropriate. However, those rules apply only to deductible payments and should not affect the general features of a tax system, whether it is a classical or an imputation system.

- (10) Hybrid permanent establishment mismatches occur where differences between the rules in the jurisdictions of permanent establishment and of residence for allocating income and expenditure between different parts of the same entity give rise to a mismatch in tax outcomes and include those cases where a mismatch outcome arises due to the fact that a permanent establishment is disregarded under the laws of the branch jurisdiction. Those mismatch outcomes may lead to a double deduction or a deduction without inclusion, and should therefore be eliminated. In the case of disregarded permanent establishments, the Member State in which the taxpayer is a resident should include the income that would otherwise be attributed to the permanent establishment.
- (11) Any adjustments that are required to be made under this Directive should in principle not affect the allocation of taxing rights between jurisdictions laid down under a double taxation treaty.
- (12) 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 mismatches that arise between the head office and permanent establishment or between two or more permanent establishments of the same entity, hybrid mismatches that arise between the taxpayer and its associated enterprises or between associated enterprises, and those resulting from a structured arrangement involving a taxpayer.

- (13) Mismatches that, in particular, result from the hybrid nature 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. The ownership, or rights of persons who are acting together, should be aggregated for the purposes of applying this requirement.
- (14) 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, conversely, an enterprise that has a significant influence in the management of the taxpayer.
- (15) It is necessary to address four categories of hybrid mismatches: first, hybrid mismatches that result from payments under a financial instrument; second, hybrid mismatches that are the consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment, including as a result of payments to a disregarded permanent establishment; third, hybrid mismatches that result from payments made by a hybrid entity to its owner, or deemed payments between the head office and permanent establishment or between two or more permanent establishments; lastly, double deduction outcomes resulting from payments made by a hybrid entity or permanent establishment.

- (16) In respect of payments under a financial instrument, a hybrid mismatch could arise where the deduction without inclusion outcome is attributable to the differences in the characterisation of the instrument or the payments made under it. If the character of the payment qualifies it for double tax relief under the laws of the payee jurisdiction, such as an exemption from tax, a reduction in the rate of tax or any credit or refund of tax, the payment should be treated as giving rise to a hybrid mismatch to the extent of the resulting undertaxed amount. A payment under a financial instrument should not, however, be treated as giving rise to a hybrid mismatch where the tax relief granted in the payee jurisdiction is solely due to the tax status of the payee or the fact that the instrument is held subject to the terms of a special regime.
- (17) In order to avoid unintended outcomes in the interaction between the hybrid financial instrument rule and the loss-absorbing capacity requirements imposed on banks, and without prejudice to State aid rules, Member States should be able to exclude from the scope of this Directive intra-group instruments that have been issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements and not for the purposes of avoiding tax.

- (18) In respect of payments made to a hybrid entity or permanent establishment, a hybrid mismatch could arise where the deduction without inclusion outcome results from differences in the rules governing the allocation of that payment between the hybrid entity and its owner in the case of a payment that is made to a hybrid entity, between the head office and permanent establishment, or between two or more permanent establishments in the case of a deemed payment to a permanent establishment. The definition of hybrid mismatch should only apply where the mismatch outcome is a result of differences in the rules governing the allocation of payments under the laws of the two jurisdictions and a payment should not give rise to a hybrid mismatch that would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.
- (19) The definition of hybrid mismatch should also capture deduction without inclusion outcomes that are the result of payments made to a disregarded permanent establishment. A disregarded permanent establishment is any arrangement that is treated as giving rise to a permanent establishment under the laws of the head office jurisdiction but which is not treated as a permanent establishment under the laws of the other jurisdiction. The hybrid mismatch rule should not apply, however, where the mismatch would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.

- (20) In respect of payments made by a hybrid entity to its owner, or deemed payments made between the head office and permanent establishment or between two or more permanent establishments, a hybrid mismatch could arise where the deduction without inclusion outcome results from the payment or deemed payment not being recognised in the payee jurisdiction. In that case, where the mismatch outcome is a consequence of the non-allocation of the payment or deemed payment, the payee jurisdiction is the jurisdiction where the payment or deemed payment is treated as being received under the laws of the payer jurisdiction. As with other hybrid entities and branch mismatches that give rise to deduction without inclusion outcomes, no hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction. In respect of this category of hybrid mismatches, however, a mismatch outcome would only arise to the extent that the payer jurisdiction allows the deduction in respect of the payment or deemed payment to be set off against an amount that is not dual-inclusion income. If the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, then the requirement to make any adjustment under this Directive could be deferred until such time as the deduction is actually set off against non dual-inclusion income in the payer jurisdiction.

- (21) The hybrid mismatch definition should also capture double deduction outcomes regardless of whether they arise as a result of payments, expenses that are not treated as payments under domestic law or as a result of amortisation or depreciation losses. As with deemed payments and payments made by a hybrid entity that are disregarded by the payee, a hybrid mismatch should only arise, however, to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income. This means that if the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, the requirement to make an adjustment under this Directive could be deferred until such time as the deduction is actually set off against non dual-inclusion income in the payer jurisdiction.

- (22) Differences in tax outcomes that are solely attributable to differences in the value ascribed to a payment, including through the application of transfer pricing, should not fall within the scope of a hybrid mismatch. Furthermore, as jurisdictions use different tax periods and have different rules for recognising when items of income or expenditure have been derived or incurred, those timing differences should not generally be treated as giving rise to mismatches in tax outcomes. However, a deductible payment under a financial instrument that cannot reasonably be expected to be included in income within a reasonable period of time should be treated as giving rise to a hybrid mismatch if that deduction without inclusion outcome is attributable to differences in the characterisation of the financial instrument or payments made under it. It should be understood that a mismatch outcome could arise if a payment made under a financial instrument is not included in income within a reasonable period of time. Such a payment should be treated as included in income within a reasonable period of time, if included by the payee within 12 months of the end of the payer's tax period or as determined under the arm's length principle. Member States could require that a payment be included within a fixed period of time in order to avoid giving rise to a mismatch outcome and secure tax control.

- (23) Hybrid transfers could give rise to a difference in tax treatment if, as a result of an arrangement to transfer a financial instrument, the underlying return on that instrument was treated as derived by more than one of the parties to the arrangement. In those cases, the payment under the hybrid transfer could give rise to a deduction for the payer while being treated as a return on the underlying instrument by the payee. This difference in tax treatment could lead to a deduction without inclusion outcome or to the generation of a surplus tax credit for the tax withheld at source on the underlying instrument. Such mismatches should therefore be eliminated. In the case of a deduction without inclusion, the same rules should apply as for neutralising mismatches from payments under a hybrid financial instrument. In the case of hybrid transfers that have been structured to produce surplus tax credits, the Member State concerned should prevent the payer from using the surplus credit to obtain a tax advantage including through the application of a general anti-abuse rule consistent with Article 6 of Directive (EU) 2016/1164.
- (24) It is necessary to provide for a rule that allows Member States to tackle discrepancies in the transposition and implementation of this Directive resulting in a hybrid mismatch despite the fact that Member States act in compliance with this Directive. Where such a situation arises and the primary rule provided for in this Directive does not apply, a secondary rule should apply. Nevertheless, the application of both the primary and secondary rules only apply to hybrid mismatches as defined by this Directive and should not affect the general features of the tax system of a Member State.

- (25) 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 involving a hybrid mismatch. 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 giving rise to a double deduction or a deduction without inclusion between third countries.
- (26) A dual resident mismatch could 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. As dual resident mismatches could give rise to double deduction outcomes, they should fall within the scope of this Directive. A Member State should deny the duplicate deduction arising in respect of a dual resident company 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.

- (27) The objective of this Directive is to improve the resilience of the internal market as a whole against hybrid mismatches. 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 result in a lack of coordination. That objective can rather, due to the cross-border nature of hybrid mismatches and the need to adopt solutions that function for the internal market as a whole, be better achieved at Union level. The Union may 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 objective.
- (28) In implementing this Directive, Member States should use the applicable explanations and examples in the OECD BEPS report on Action 2 as a source of illustration or interpretation to the extent that they are consistent with the provisions of this Directive and with Union law.

- (29) The hybrid mismatch rules in Article 9(1) and 9(2) only apply to the extent that the situation involving a taxpayer gives rise to a mismatch outcome. No mismatch outcome should arise when an arrangement is subject to adjustment under Article 9(5) or 9a and, accordingly, arrangements that are subject to adjustment under those parts of this Directive should not be subject to any further adjustment under the hybrid mismatch rules.
- (30) Where the provisions of another directive, such as those in Council Directive 2011/96/EU¹, lead to the neutralisation of the mismatch in tax outcomes, there should be no scope for the application of the hybrid mismatch rules provided for in this Directive.
- (31) The Commission should evaluate the implementation of this Directive five 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.
- (32) Directive (EU) 2016/1164 should therefore be amended accordingly,

HAS ADOPTED THIS DIRECTIVE:

¹ Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 345, 29.12.2011, p. 8).

Article 1

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

(1) Article 1 is replaced by the following:

“Article 1

Scope

1. This Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country.
2. Article 9a also applies to all entities that are treated as transparent for tax purposes by a Member State.”.

(2) Article 2 is amended as follows:

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

“For the purposes of Articles 9 and 9a:

- (a) Where the mismatch outcome arises under points (b), (c), (d), (e) or (g) of the first subparagraph of point (9) of this Article or where an adjustment is required under Article 9(3) or Article 9a, the definition of associated enterprise is modified so that the 25 percent requirement is replaced by a 50 percent requirement;

- (b) a person who acts together with another person in respect of the voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other person;
 - (c) 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.”;
- (b) point (9) is replaced by the following:

“(9) ‘hybrid mismatch’ means a situation involving a taxpayer or, with respect to Article 9(3), an entity where:

- (a) a payment under a financial instrument gives rise to a deduction without inclusion outcome and:
 - (i) such payment is not included within a reasonable period of time; and
 - (ii) the mismatch outcome is attributable to differences in the characterisation of the instrument or the payment made under it.

For the purposes of the first subparagraph, a payment under a financial instrument shall be treated as included in income within a reasonable period of time where:

- (i) the payment is included by the jurisdiction of the payee in a tax period that commences within 12 months of the end of the payer's tax period; or
 - (ii) it is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future tax period and the terms of payment are those that would be expected to be agreed between independent enterprises;
- (b) a payment to a hybrid entity gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction where the hybrid entity is established or registered and the jurisdiction of any person with a participation in that hybrid entity;
- (c) a payment to an entity with one or more permanent establishments gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments between the head office and permanent establishment or between two or more permanent establishments of the same entity under the laws of the jurisdictions where the entity operates;

- (d) a payment gives rise to a deduction without inclusion as a result of a payment to a disregarded permanent establishment;
- (e) a payment by a hybrid entity gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction;
- (f) a deemed payment between the head office and permanent establishment or between two or more permanent establishments gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction;
or
- (g) a double deduction outcome occurs.

For the purposes of this point (9):

- (a) a payment representing the underlying return on a transferred financial instrument shall not give rise to a hybrid mismatch under point (a) of the first subparagraph where the payment is made by a financial trader under an on-market hybrid transfer provided the payer jurisdiction requires the financial trader to include as income all amounts received in relation to the transferred financial instrument;
- (b) a hybrid mismatch shall only arise under points (e), (f) or (g) of the first subparagraph to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income;

- (c) a mismatch outcome shall not be treated as a hybrid mismatch unless it arises between associated enterprises, between a taxpayer and an associated enterprise, between the head office and permanent establishment, between two or more permanent establishments of the same entity or under a structured arrangement.

For the purposes of this point (9) and Articles 9, 9a and 9b:

- (a) ‘mismatch outcome’ means a double deduction or a deduction without inclusion;
- (b) ‘double deduction’ means a deduction of the same payment, expenses or losses in the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered (payer jurisdiction) and in another jurisdiction (investor jurisdiction). In the case of a payment by a hybrid entity or permanent establishment the payer jurisdiction is the jurisdiction where the hybrid entity or permanent establishment is established or situated;
- (c) ‘deduction without inclusion’ means the deduction of a payment or deemed payment between the head office and permanent establishment or between two or more permanent establishments in any jurisdiction in which that payment or deemed payment is treated as made (payer jurisdiction) without a corresponding inclusion for tax purposes of that payment or deemed payment in the payee jurisdiction. The payee jurisdiction is any jurisdiction where that payment or deemed payment is received, or is treated as being received under the laws of any other jurisdiction;

- (d) 'deduction' means the amount that is treated as deductible from the taxable income under the laws of the payer or investor jurisdiction. The term 'deductible' shall be construed accordingly;
- (e) 'inclusion' means the amount that is taken into account in the taxable income under the laws of the payee jurisdiction. A payment under a financial instrument shall not be treated as included to the extent that the payment qualifies for any tax relief solely due to the way that payment is characterised under the laws of the payee jurisdiction. The term 'included' shall be construed accordingly;
- (f) 'tax relief' means a tax exemption, reduction in the tax rate or any tax credit or refund (other than a credit for taxes withheld at source);
- (g) 'dual inclusion income' means any item of income that is included under the laws of both jurisdictions where the mismatch outcome has arisen;
- (h) 'person' means an individual or entity;
- (i) 'hybrid entity' means any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure of one or more other persons under the laws of another jurisdiction;
- (j) 'financial instrument' means any instrument to the extent that it gives rise to a financing or equity return that is taxed under the rules for taxing debt, equity or derivatives under the laws of either the payee or payer jurisdictions and includes a hybrid transfer;

- (k) ‘financial trader’ is a person or entity engaged in the business of regularly buying and selling financial instruments on its own account for the purposes of making a profit;
 - (l) ‘hybrid transfer’ means any arrangement to transfer a financial instrument 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 that arrangement;
 - (m) ‘on-market hybrid transfer’ means any hybrid transfer that is entered into by a financial trader in the ordinary course of business, and not as part of a structured arrangement;
 - (n) ‘disregarded permanent establishment’ means any arrangement that is treated as giving rise to a permanent establishment under the laws of the head office jurisdiction and is not treated as giving rise to a permanent establishment under the laws of the other jurisdiction.”;
- (c) the following points 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 outcome 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.”.

(3) 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 accounting standards other than the International Financial Reporting Standards or the national financial reporting system of a Member State.”.

(4) Article 9 is replaced by the following:

“Article 9

Hybrid mismatches

1. To the extent that a hybrid mismatch results in a double deduction:
 - (a) the deduction shall be denied in the Member State that is the investor jurisdiction; and
 - (b) where the deduction is not denied in the investor jurisdiction, the deduction shall be denied in the Member State that is the payer jurisdiction.

Nevertheless, any such deduction shall be eligible to be set off against dual inclusion income whether arising in a current or subsequent tax period.

2. To the extent that a hybrid mismatch results in a deduction without inclusion:
 - (a) the deduction shall be denied in the Member State that is the payer jurisdiction; and
 - (b) where the deduction is not denied in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome shall be included in income in the Member State that is the payee jurisdiction.

3. A Member State shall deny a deduction for any payment by a taxpayer to the extent that such payment directly or indirectly funds deductible expenditure giving rise to a hybrid mismatch through a transaction or series of transactions between associated enterprises or entered into as part of a structured arrangement except to the extent that one of the jurisdictions involved in the transaction or series of transactions has made an equivalent adjustment in respect of such hybrid mismatch.
4. A Member State may exclude from the scope of:
 - (a) point (b) of paragraph 2 of this Article hybrid mismatches as defined in points (b), (c), (d) or (f) of the first subparagraph of Article 2(9);
 - (b) points (a) and (b) of paragraph 2 of this Article hybrid mismatches resulting from a payment of interest under a financial instrument to an associated enterprise where:
 - (i) the financial instrument has conversion, bail-in or write down features;
 - (ii) the financial instrument has been issued with the sole purpose of satisfying loss absorbing capacity requirements applicable to the banking sector and the financial instrument is recognised as such in the taxpayer's loss absorbing capacity requirements;
 - (iii) the financial instrument has been issued
 - in connection with financial instruments with conversion, bail-in or write down features at the level of a parent undertaking;

- at a level necessary to satisfy applicable loss absorbing capacity requirements;
 - not as part of a structured arrangement; and
- (iv) the overall net deduction for the consolidated group under the arrangement does not exceed the amount that it would have been had the taxpayer issued such financial instrument directly to the market.

Point (b) shall apply until 31 December 2022.

5. To the extent that a hybrid mismatch involves disregarded permanent establishment income which is not subject to tax in the Member State in which the taxpayer is resident for tax purposes, that Member State shall require the taxpayer to include the income that would otherwise be attributed to the disregarded permanent establishment. This applies unless the Member State is required to exempt the income under a double taxation treaty entered into by the Member State with a third country.
6. 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.”.

(5) The following Articles are inserted:

“Article 9a

Reverse hybrid mismatches

1. Where one or more associated non-resident entities holding in aggregate a direct or indirect interest in 50 percent or more of the voting rights, capital interests or rights to a share of profit in a hybrid entity that is incorporated or established in a Member State are located in a jurisdiction or jurisdictions that regard the hybrid entity as a taxable person, the hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that that income is not otherwise taxed under the laws of the Member State or any other jurisdiction.
2. Paragraph 1 shall not apply to a collective investment vehicle. For the purposes of this Article, ‘collective investment vehicle’ means an investment fund or vehicle that is widely held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established.

Article 9b

Tax residency mismatches

To the extent that a deduction for payment, expenses or losses of a taxpayer who is resident for tax purposes in two or more jurisdictions is deductible from the tax base in both jurisdictions, the Member State of the taxpayer shall deny the deduction to the extent that the other jurisdiction allows the duplicate deduction to be set off against income that is not 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 concerned shall deny the deduction.”.

- (6) In Article 10(1), the following subparagraph is added:

“By derogation from the first subparagraph, the Commission shall evaluate the implementation of Articles 9 and 9b, and in particular the consequences of the exemption set in point (b) of Article 9(4), by 1 January 2022 and report to the Council thereon.”.

- (7) In Article 11, the following paragraph is inserted:

“5a. By way of derogation from paragraph 1, Member States shall, by 31 December 2019, adopt and publish the laws, regulations and administrative provisions necessary to comply with Article 9. They shall communicate to the Commission the text of those provisions without delay.

They shall apply those provisions from 1 January 2020.

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.”.

Article 2

1. Member States shall adopt and publish, by 31 December 2019, 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 2020.

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.
3. By way of derogation from paragraph 1, Member States shall, by 31 December 2021, adopt and publish the laws, regulations and administrative provisions necessary to comply with Article 9a of Directive (EU) 2016/1164. They shall communicate to the Commission the text of those provisions without delay.

They shall apply those provisions from 1 January 2022.

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.

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 ...,

For the Council

The President
