HYBRID MISMATCHES: WHERE U.S. TAX LAW AND A.T.A.D. MEET

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This article focuses on the interaction between certain hybrid mismatch provisions of A.T.A.D. 2 and certain provisions of U.S. tax law. As will be shown in later examples, A.T.A.D. 2 can be seen as a concerted E.U. effort to target overseas earnings of U.S. multinationals.

BACKGROUND

European Council Directive 2016/1164 ("A.T.A.D. 1") was adopted on July 12, 2016. It lays out the rules against tax avoidance practices directly affecting the functionality of the E.U.'s internal market.

It contains the following provisions, some of which were inspired by U.S. tax law, while others appear to have inspired the 2017 Tax Cuts and Jobs Act ("T.C.J.A."):

- An interest deduction limitation rule very similar to revised Code §163(j)
- Exit tax provisions that resemble the underlying logic of Code §367
- Controlled Foreign Corporation ("C.F.C.") provisions that resemble U.S. C.F.C. provisions
- Hybrid mismatches arising in transactions involving the corporate tax systems of E.U. Member States[1]

A.T.A.D. 2, adopted on May 29, 2017, entirely replaces the hybrid mismatch rules of A.T.A.D.1.[2] It includes rules on hybrid mismatches with non-E.U. countries, where at least one of the parties involved is a corporate taxpayer, or an entity in an E.U. Member State. This follows a request by the Economic and Financial Affairs Council of the E.U. for "rules consistent and no less effective" than those recommended by the O.E.C.D. under the B.E.P.S. initiative.[3] In addition, A.T.A.D. 2 adds provisions on reverse hybrid mismatches, or imported mismatches, and tax residency mismatches.[4]

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1 A.T.A.D. 1 must be implemented by E.U. Member States by December 31, 2018.

2 Article 9 of A.T.A.D. 2. A.T.A.D. 2 must be implemented by E.U. Member States by December 31, 2019. Only reverse hybrid mismatch rules are subject to an extended deadline for implementation of December 31, 2021.

3 Preamble of A.T.A.D. 2 at (5) with reference to the O.E.C.D. Report on Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2 — 2015 Final Report ("O.E.C.D. B.E.P.S. Report on Action 2").

4 Article 9a of A.T.A.D. 2.

DEFINITION OF HYBRID MISMATCHES UNDER A.T.A.D. 2

Hybrid mismatches exist in the following situations involving taxpayers or entities:[5]

- **Hybrid Transactions**: Certain payments under financial instruments that give rise to an income deduction in the hands of the payor but no income inclusion in the hands of the payee constitute hybrid mismatches. Payments fall under this category when (i) they are not included in the payee's income within a reasonable timeframe[6] and (ii) the mismatch in treatment is due to differences in the characterization of the payment or the underlying instrument. For this purpose, a financial instrument is defined as any instrument giving rise to either a financing or an equity return subject to tax laws relating to debt, equity, or derivatives under the laws of either the payor's or the payee's jurisdiction.[7]

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- **Hybrid Entities**: Payments to hybrid entities that give rise to an income deduction in the hands of the payor and no income inclusion in the hands of the payee constitute a hybrid mismatch where there is a difference in the allocation of the payment between the jurisdiction in which the hybrid entity is established or registered and the jurisdiction of any person holding an interest in such hybrid entity.[8] For purposes of both A.T.A.D. 1 and A.T.A.D. 2, a hybrid entity is defined as an entity or arrangement treated as a taxable entity under the laws of one jurisdiction and whose income or expenses are considered belonging to one or more other persons (entities or individuals) under the laws of another jurisdiction. An example for a hybrid entity falling within the scope of this rule would be an entity treated as a taxpayer under the laws of an E.U. Member State that made an election to be treated as a partnership or a disregarded entity for U.S. income tax purposes.

- **Permanent Establishments**: Certain payments to or from permanent establishments give rise to hybrid mismatches.

- **Disregarded Payments**: Deductible payments by hybrid entities that are not included in income by the payee because the payment is disregarded under the laws of the payee's jurisdiction are another form of hybrid mismatch.

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5 Article 2(9) of A.T.A.D. 2.

6 For this purpose, a reasonable timeframe means either (i) an inclusion within 12 months of the end of the payer's tax period or (ii) a reasonable future inclusion expenctancy, when the terms of the payment are arm's length.

7 An exception will apply if these rules would lead to unintended outcomes in the interaction between the hybrid financial instrument rule and the loss-absorbing capacity requirements imposed on banks. Without prejudice to State Aid rules, E.U. Member States should be entitled to exclude from the scope of A.T.A.D. 2 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. Preamble of A.T.A.D. 2 at (17).

8 However, if the payee is treated as a tax-exempt entity under the laws of its country, this rule should not apply since this would result in a hybrid mismatch in any event. The same principle should apply to a deduction without inclusion in the case of payments by disregarded permanent establishments. Preamble of A.T.A.D. 2 at (18) and (19).

Such payments only constitute hybrid mismatches if the jurisdiction of the payor allows the deduction from income that is not included in both the payor's and the payee's hands.

- **Double Deductions**: Certain payments resulting in double deductions constitute hybrid mismatches if the jurisdiction of the payor allows a deduction from income that is not included in both the payor's and the payee's hands.

  For this purpose, a double deduction or a deduction without inclusion does not constitute a hybrid mismatch unless it arises

  - between associated enterprises,
  - between a taxpayer and associated enterprises,
  - between a head office and a permanent establishment,
  - between two or more permanent estabalishments of the same entity, or
  - under a structured arrangement.[9]

  Generally, for hybrid mismatch and reverse mismatch purposes, an associated enterprise is defined as follows:[10]

  - An entity in which the taxpayer has a direct or indirect voting, capital, or profits interest of 50% or more
  - An entity or individual holding a direct or indirect interest by vote, capital ownership, or profits in the taxpayer of 50% or more
  - An entity that is part of a consolidated group for financial accounting purposes
  - An enterprise in which the taxpayer has a significant management influence
  - An enterprise that has a significant management influence in the taxpayer

  Further, for purposes of defining associated enterprises, a person acting with the owner of the voting rights or the capital of an entity is deemed to own all the voting rights or the capital of such owner.

TREATMENT OF HYBRID MISMATCHES UNDER A.T.A.D. 2

The general treatment of hybrid mismatches with respect to payments that involve at least one party based in an E.U. Member State under A.T.A.D. 2 is as follows:

- If a hybrid mismatch results in a double deduction, the state of the recipient

9 Article 2(9) of A.T.A.D. 2.

10 Article 2(4) of A.T.A.D. 2.

of the payment must deny the deduction. If the recipient's state does not deny the deduction, the payor's state must deny the deduction. The latter could occur when the recipient's state is not an E.U. Member State, such as the U.S.

- If a hybrid mismatch results in a deduction for the payor with no income inclusion for the recipient, the payor's state must deny the deduction. If the deduction is not denied, the payment must be included in income in the recipient's state. The latter could occur when, for instance, the payor is located in the U.S.
- A state can disallow a deduction for a payment when the payment directly or indirectly funds a deductible expenditure giving rise to a hybrid mismatch through a transaction or series of transactions between certain related parties or entered into as part of a structured arrangement, except to the extent that one of the jurisdictions involved has already made an equivalent adjustment with respect to the hybrid mismatch.

Accordingly, an ordering rule sets forth which state will first make an adjustment, such as a denial of deductbility. A.T.A.D. 2 includes limitations to the scope. More specifically, it makes the following clarifications:

- The adjustment to the mismatch shall be limted to the "extent of the resulting undertaxed amount."[11]
- Any adjustments that are required to be made under A.T.A.D. 2 should, in principle, not affect the allocation of taxing rights between jurisdictions laid down under a double taxation treaty.[12]
- Where mismatches are subject to adjustments under the Directive or neutralized under similar rules, no further adjustments under A.T.A.D. 2 shall be required.[13]

In this context, it will be interesting to see how, once A.T.A.D. 2 becomes effective, the ordering rules will be aligned with these limitations in practice.

TREATMENT OF REVERSE HYBRID MISMATCHES AND U.S. TAX LAW

When (i) one or more nonresident associated enterprises own a direct or indirect 50% interest (by vote, capital, or profits) in a hybrid entity that is incorporated or established in an E.U. Member State and (ii) the nonresident associated entities' jurisdictions treat the hybrid entity as the taxpayer, that E.U. Member State must tax the income of the entity as the income of a resident entity to the extent that the income is not otherwise taxed under the laws of the Member State or any other jurisdiction.

The following constitutes an example of a reverse hybrid mismatch that would fall under A.T.A.D. 2:

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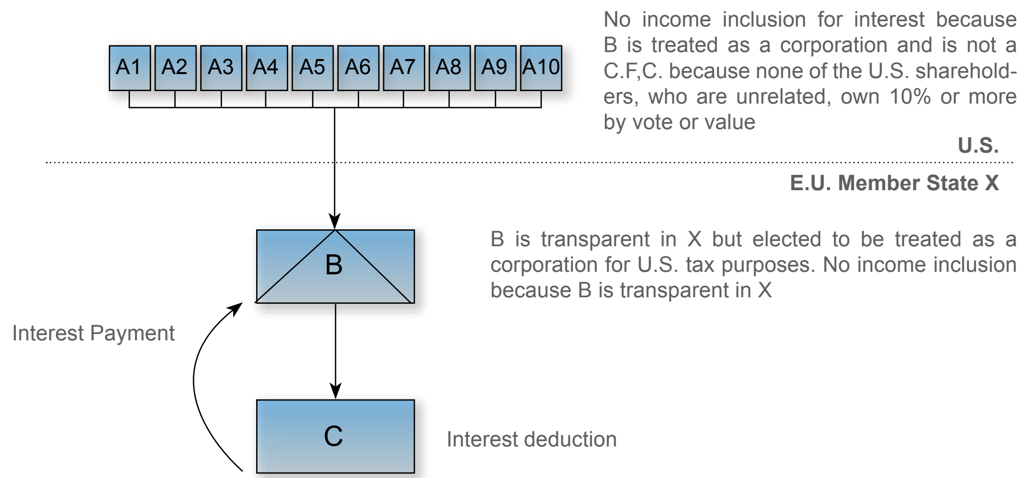
11 Preamble of the A.T.A.D. 2 at (16).

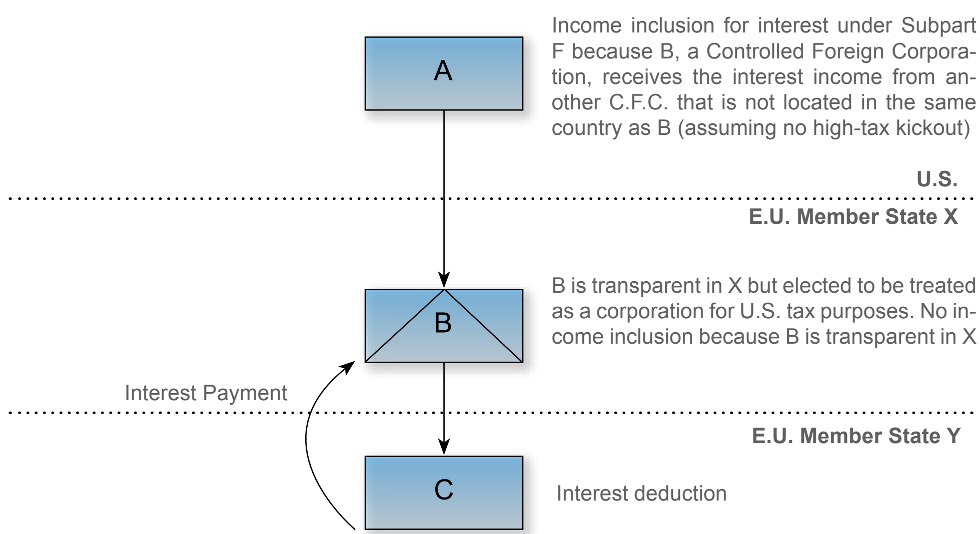
12 Preamble of the A.T.A.D. 2 at (11).

13 Preamble of the A.T.A.D. 2 at (29) and (30).



In the above example, E.U. Member State X must tax B's income, since the interest income would not otherwise be included in income by E.U. Member State X nor the U.S.

The following illustration constitutes almost the same scenario but where the interest income is taxed to A under the U.S. C.F.C. regime:[14]

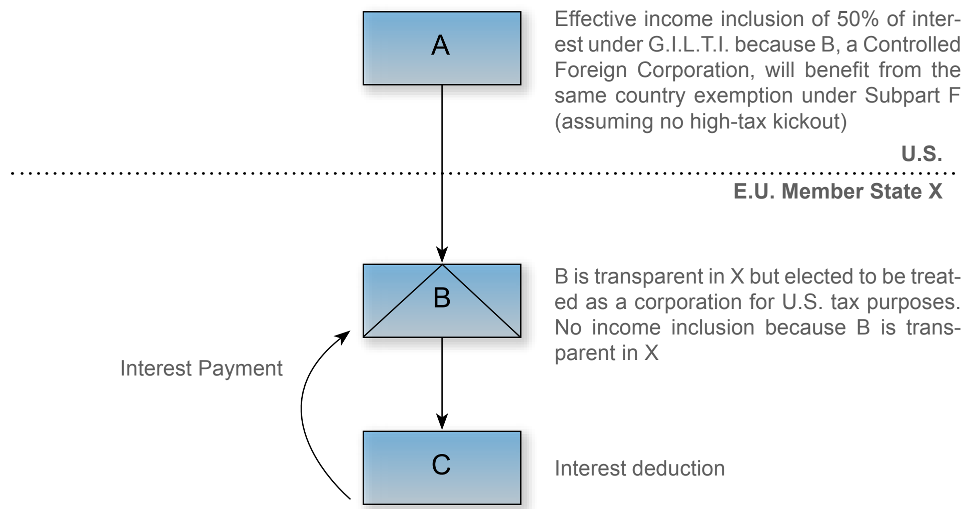


In this scenario, the interest income would be fully included in A's U.S. gross income. Since A.T.A.D. 2 provides that as long as the income is "otherwise taxed under the

[14] Since C is not incorporated in the same E.U. Member State as B, the interest is subject to a Subpart F Income inclusion under the C.F.C. regime in the hands of A. This assumes the exemption from Subpart F inclusion under the high-tax kickout does not apply. The threshold is 90% of U.S. tax, which is 21% for corporations from 2018 onwards, hence 18.9%.

laws of the E.U. Member State or any other jurisdiction," E.U. Member State X would not be required to tax B on the income.

In comparison, if B and C were resident in the same country, the outcome, taking into account the changes under the T.C.J.A., will differ:



Here, B is a C.F.C. owned by A. Thus, A has a yearly income inclusion of B's Subpart F Income. As a general rule, interest income constitutes Subpart F Income and C's interest payment must be included in A's gross income. However, a Subpart F exclusion exists for interest received from related entities that operate an actual trade or business in the same country as the C.F.C.'s country of incorporation. As a result, C's interest payment to B would not constitute Subpart F Income at B's level. Since it is excluded from Subpart F, and assuming that the tax rate in Member State X is not higher than 18.9%, the interest income would be included in A's gross income under G.I.L.T.I. Given that A is a corporation, it would be entitled to a 50% deduction on such inclusion and only 50% of that interest income would be taxable to A. In this fact pattern, it is unclear whether Member State X would be required to include the remaining 50% of the interest income and tax it to B.

HYBRID PAYMENTS UNDER U.S. LAW AND A.T.A.D.2

New Code §267A disallows a deduction for certain related party amounts paid or accrued pursuant to (i) a hybrid transaction or (ii) by, or to, a hybrid entity.

This Code section only applies to related party interest, royalty amounts paid or accrued to a related party if

- the payment is not subject to tax or a corresponding inclusion in the income of the related party under the tax laws of the related party's country, or
- the related party is allowed a deduction with respect to such amount.

In broad terms, this would be referred to as a deduction without inclusion or as a double deduction by A.T.A.D. 2.

For this purpose, a person is a related person with respect to the payor if

- the person is an individual, corporation, partnership, trust, or estate that controls or is controlled by the payor, or
- such person is a corporation, partnership, trust, or estate that is controlled by the same person or persons that control the payor.

Under this new U.S. hybrid payment provision, "control" is defined as[15]

- more than 50% direct or indirect ownership, by vote or value, of a corporation, or
- more than 50% direct or indirect ownership, by value, of the beneficial interests in a partnership, trust, or estate.

"New Code §267A disallows a deduction for certain related party amounts paid or accrued pursuant to (i) a hybrid transaction or (ii) by, or to, a hybrid entity."

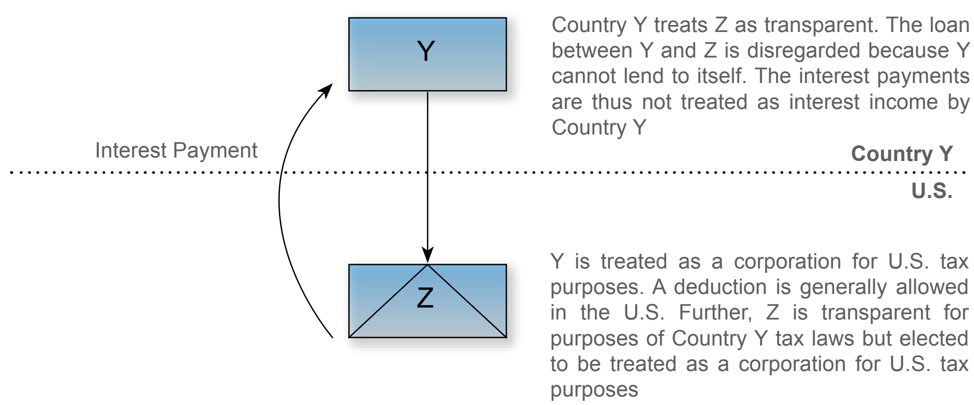
Regarding hybrid transactions, Code §267A applies to any transaction, series of transactions, agreement, or instrument giving rise to payments that are treated as royalty or interest payments under U.S. law but not by the country in which the recipient is subject to tax or of which the recipient is a resident for tax purposes.

Regarding hybrid entities, Code §267A applies to are any entities that are either

- non-U.S. entities that are treated as transparent for U.S. tax purposes but not as transparent in their country of residence or the country where they are subject to tax, or
- non-U.S. entities that are not treated as transparent for U.S. tax purposes but are treated as transparent for purposes of the tax laws of their country of residence or the country where they are subject to tax.

Under an exception, a disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. Shareholder under Code §951(a).

The following describes the scenario targeted by Code §267A in the case of a hybrid payment:



15 Indirect and constructive ownership rules apply. See Code §954(d)(3), as referred to by Code §267A(b)(2).

Under Code §267A, the U.S. would deny the deduction if interest paid by Z to Y is not included in Y's income. A similar scenario to this fact pattern would be a hybrid instrument that is treated as debt from a U.S. tax perspective while considered to be equity under the tax law of the recipient's jurisdiction, such as the participation exemption under the E.U. Parent/Subsidiary Directive as implemented into local law.

Contrary to the A.T.A.D. 2, Code §267A does not include an ordering rule.[16] In other words, as long as there is no double deduction nor deduction or non-inclusion for the interest paid by Z to Y, Code §267A is not triggered. In our example, if an inclusion were to occur on the recipient's side in Country Y, Code §267A would not deny the deduction. Hence, from a mere U.S. perspective the taxpayer appears to be in a position to choose – or "cherry-pick" – the tax benefit (*i.e.*, either treating the interest payment as tax deductible in the U.S. and thereby reducing its U.S. taxable profit while subjecting it to tax in Country Y or vice versa). Typically, the choice will depend on the effective tax rate in each country taking into account tax attributes such as the availability of N.O.L. carryforwards, as well as the applicable tax rate. However, if Country Y is an E.U. Member State that has implemented A.T.A.D. 2, in principle, the ordering rules described above would apply. In this case, it would mean that the U.S. as the payor's country would have to deny deductibility – a result the I.R.S. will definitely not object to. It will be interesting to see how the tension between these anti-abuse provisions will be handled by the two countries at issue, especially in cases where the taxpayer does not follow the ordering rule – as neither Code §267A nor A.T.A.D. 2 appear to prevent the taxpayer from doing so.

CONCLUSION

As with other provisions affecting international transactions, A.T.A.D. 2 cannot be looked at solely from one side of the transaction. When dealing with transactions involving an E.U. Member State and the U.S., A.T.A.D. 2 and U.S. tax law must be looked at simultaneously, especially with regard to hybrid payments.[17] This is especially important not just to avoid double inclusions but also to plan for the country of inclusion or deduction.

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[16] Note that regulations mandated under Code §267A(e) to carry out the purposes of this new rule have not been promulgated as of August 2018.

[17] Please note that new Code §245A also contains provisions relating to certain hybrid dividends. The present article does not discuss this provision.

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