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**COMMISSION STAFF WORKING DOCUMENT**  
*Accompanying the document*

**Proposal for a Council Directive**

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

{COM(2016) 687 final}

## **Introduction**

The taxation of multinational companies has come under scrutiny by tax administrations, tax experts and the general public in recent years. Some companies use aggressive tax planning techniques to exploit loopholes in tax systems and mismatches between national rules to reduce their tax liabilities. These activities undermine the fair burden sharing amongst taxpayers and fair competition between businesses. The economic crisis of recent years requires contributions to the consolidation of public finances from all taxpayers. Following the crisis and the increased revenue needs, the OECD, endorsed by the G20, launched the Base Erosion and Profit Shifting (BEPS) project that came to completion in October 2015<sup>1</sup>.

The European Union fully supports the OECD/G20 BEPS conclusions. As it is essential for the EU that Member States implement the OECD/G20 BEPS outcomes in a coordinated way, the Commission tabled a proposal for an Anti- Tax Avoidance Directive on 28 January 2016<sup>2</sup>. The ECOFIN Council reached a political agreement on the Anti-Tax Avoidance Directive on 20 June 2016.

The Anti- Tax Avoidance Directive<sup>3</sup> lays down rules against tax avoidance practices that directly affect the functioning of the internal market. The Anti-Tax Avoidance Directive responds to the BEPS project as well as to demands from the European Parliament, several Member States, businesses and civil society, and certain international partners for a stronger and more coherent EU approach against corporate tax abuse. The schemes targeted by the Anti-Tax Avoidance Directive involve situations where taxpayers act against the actual purpose of the law, taking advantage of disparities between national tax systems, in order to reduce their tax bill.

The use of hybrid mismatch arrangements is a widespread aggressive tax planning technique which results in a substantial erosion of the taxable bases of Member States. The OECD has addressed hybrid mismatch arrangements in its report on Action item 2 'Neutralising the Effects of Hybrid Mismatch Arrangements' (hereinafter: the OECD report). The Anti-Tax Avoidance Directive also contains rules to address these arrangements. The hybrid mismatch rules in the Anti-Tax Avoidance Directive cover the most common forms of hybrid mismatches, namely hybrid entity and hybrid financial instrument mismatches, but only within the EU.

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.

## **Political context**

It is widely recognised that hybrid mismatches involving third countries should be countered as well. Therefore, as part of the final compromise on the Anti-Tax Avoidance Directive that was reached on 20 June 2016, the ECOFIN Council issued a statement on hybrid mismatches. In this statement the ECOFIN Council requested 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

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<sup>1</sup> <http://www.oecd.org/tax/beps/>

<sup>2</sup> COM(2016) 26

<sup>3</sup> Council Directive (EU) 2016/1164, OJ L 193/1.

recommended by the OECD BEPS report on Action 2, with a view to reaching an agreement by the end of 2016."

In order to provide for a comprehensive framework consistent with and no less effective than the rules recommended by the OECD, this proposal for a Directive also includes rules on hybrid permanent establishment mismatches, imported mismatches, so-called hybrid transfers and dual resident mismatches.

## **Related policy initiatives**

### *Code of Conduct*

The Code of Conduct for Business Taxation was set up in 1998 to address harmful tax competition within the EU. In 2009, the Code Group started examining anti-abuse issues related to hybrid mismatches. It first concentrated its work on hybrid entities and hybrid permanent establishments (PEs). Guidance on hybrid entities mismatches between Member States was agreed in December 2014, on the basis of the fixed alignment approach. It would compel Member States to change their qualification of the hybrid entity from transparent to non-transparent in double deduction situations, or from non-transparent to transparent in deduction/no inclusion cases. Guidance was agreed in June 2015 for hybrid PEs, and in December 2015 for hybrid entities in situations involving third countries. In January 2016 guidance was agreed for hybrid PEs in situations involving third countries.

Although the rules in the guidance as agreed by the Code Group do not entirely correspond to the rules in the Anti-Tax Avoidance Directive and the rules in this proposal, it should be noted that the intended result is the same: to neutralise the effect of hybrid mismatches without a complete re-characterisation of the entity, instrument or commercial presence involved.

### *European Parliament*

The European Parliament has been closely examining the issue of tax avoidance, in particular through the Economic and Monetary Affairs (ECON) Committee, the Tax Rulings and Other Measures Similar in Nature or Effect (TAXE) Committee and the Committee of Inquiry to investigate alleged contraventions and maladministration in the application of Union law in relation to money laundering, tax avoidance and tax evasion (PANA).

There is a clear message from the European Parliament that tax avoidance needs to be addressed, also by closing down hybrid mismatches arrangements. In the legislative resolution on the Anti-Tax Avoidance Directive of 8 June 2016 the European Parliament adopted amendments extending the rules on hybrid mismatch arrangements to hybrid mismatch situations involving third countries.

### *Fiscal State aid*

Some of the tax planning structures that have been investigated by the Commission in the context of State aid control involve hybrid mismatch arrangements. These structures are put in place by multinational enterprises (MNEs) which are able to set up legal or commercial offices in multiple countries to facilitate their cross-border operations. Those opportunities are not available to small and medium-sized enterprises (SMEs) whose businesses are generally limited to the domestic market.

MNEs can set up hybrid mismatch structures, such as a hybrid permanent establishment in a third state or a reverse hybrid entity in a Member State, to reduce their taxable base in the Member States involved. Hybrid mismatch arrangements can lead to considerable amounts of revenue loss by Member States, involving tens of millions of euros.

**Annex 1** includes three simplified figures of hybrid mismatch structures. These kinds of hybrid mismatch structures have also been identified in the OECD report and will be addressed by this proposal.

## **Consultations**

Hybrid mismatches have been subject to extensive consultations. The rules on hybrid mismatches build on the outcomes of the OECD/G20 BEPS project, the discussions in the Code of Conduct Group and, in particular, the discussions during the working parties on the Anti-Tax Avoidance Directive.

### *Position of Member States*

During the working parties on the Anti-Tax Avoidance Directive several draft proposals on hybrid mismatches, including those involving third countries, were tabled by the Presidency and other Member States respectively. These proposals were examined, but given the complexity of the issue it turned out that there was not enough time to reach a conclusive outcome. However, as demonstrated by the statement of the ECOFIN Council, it is clear that there is a strong demand by the Member States to address those hybrid mismatch situations that are not yet covered by the Anti-Tax Avoidance Directive.

The elements of this proposal have been discussed with Member States' delegations at the Working Party IV meeting of 26 July 2016. It has become apparent that there is a clear preference among a large majority of Member States to address the various kinds of hybrid mismatch arrangements that are now covered by the proposal. Five Member States have provided input in writing to assist with the drafting of the proposal for a Directive.

### *Other consultations*

The works on the action items, including Action item 2 'Neutralising the Effects of Hybrid Mismatch Arrangements', of the BEPS project have been very inclusive, with public consultations and the release of discussion drafts and working documents. Most Member States have been involved in the technical discussions on Action item 2 of the BEPS project. The OECD has invited interest parties to comment on the Discussion draft on Neutralising the Effects of Hybrid Mismatch Arrangements related to Action 2 of the BEPS Action Plan released on 19 March 2014. A Public Consultation was held on 15 May 2014. The OECD received 70 public comments from various parties adding up to 463 pages in total. Most public comments were received from businesses, business organisations and tax advisors, but NGOs and an academic have provided comments as well. Most respondents support, or appreciate, the intention to address hybrid mismatch arrangements. The public comments received mainly focus on the technical aspects of the rules in the discussion drafts. The public comments can be found on the OECD's website:

<http://www.oecd.org/tax/aggressive/comments-action-2-hybrid-mismatch-arrangements.pdf>.

Finally, 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. Many representatives supported the approach to have a comprehensive proposal on hybrids consistent with the OECD report.

## **Rationale**

The existence of profit shifting and base eroding practises is demonstrated in many studies.<sup>4</sup> Although the extent of these practices and its impact on total tax revenues is hard to measure, it might be considerable. However, tax planning schemes are often complex and might involve several combined tax planning tools. According to the OECD<sup>5</sup> the effective tax rates (ETR) of MNEs affiliates are on average 2.5 to 5 percentage points lower compared to non-MNE entities with similar characteristics. This could be partially attributable to the fact that MNEs can take advantage of mismatches between tax systems whereas non-MNEs are not able to do so. Several OECD reports have identified hybrid mismatch arrangements as playing a major role in aggressive tax planning and highlighted the negative impact of such arrangements on tax revenues as well as competition, transparency and fairness

## **Problems addressed**

The OECD report focuses on three possible outcomes under a hybrid mismatch arrangement: a deduction/no inclusion outcome (D/Ni outcome), a double deduction outcome (DD outcome) or an indirect D/Ni outcome. The Public Discussion Draft on Branch Mismatch Structures released on 22 August 2016 also focuses on non-taxation without inclusion.

A great number of 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. The OECD has included 80 examples of hybrid entity and hybrid financial instrument mismatches in its report. The OECD report also deals with so-called imported mismatches and hybrid transfers. 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. Hybrid transfers are arrangements 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. Furthermore, the OECD report deals with dual resident mismatches, although strictly speaking they do not involve a hybrid entity or a hybrid financial instrument. The Public Discussion Draft on Branch Mismatch Structures includes several examples of hybrid permanent establishment mismatches.

The study on Structures of Aggressive Tax Planning and Indicators<sup>6</sup> (hereinafter the "ATP Study"), whose results were published in January 2016, has identified seven structures that are most commonly used by MNEs that engage in aggressive tax planning.

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<sup>4</sup> See also COM (2016) 23, p. 6.

<sup>5</sup> OECD (2015), *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, p. 58-60, 101, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

<sup>6</sup> Ramboll Management Consulting and Corit Advisory (2016), *Study on Structures of Aggressive Tax Planning and Indicators*, European Commission Taxation Paper, 61.

**Annex 2** includes two aggressive tax planning structures identified in the ATP Study that involve a hybrid entity and a hybrid loan structure, both resulting in a D/NI outcome. These structures will be addressed by this proposal as well.

The ATP study also revealed that the lack of anti-abuse rules is striking in the area of hybrid entities. Twenty-five Member States<sup>7</sup> have been identified as having no rule to counter mismatches in the qualification of a local partnership or company by another state. In eighteen Member States, the tax qualification of a foreign partnership does not follow the qualification of the other state. The lack of anti-abuse rules to counter mismatches in hybrid financial instruments is also identified by the study as an important factor in the ability of MNEs to set up ATP structures. More countries have rules in place to counter mismatches in hybrid financial instruments than in hybrid entities.

### **Approach chosen**

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.

### **Objectives**

This proposal is intended to address mismatch situations attributable to differences in the legal characterisation of an entity or a financial instrument. Furthermore, this proposal addresses mismatch situations as a result of different rules on the treatment of a commercial presence as a permanent establishment. Under the rules of this proposal Member States will have the obligation to deny the deduction of a payment by a taxpayer or to require the taxpayer to include a payment or a profit in its taxable income, as the case may be.

### **Features**

The proposal for a Directive addresses the following hybrid mismatch arrangements that were not covered by the Anti-Tax Avoidance Directive:

- a hybrid entity mismatch involving a third country leading to a double deduction;
- a hybrid entity mismatch involving a third country leading to a deduction without an inclusion.
- a hybrid financial instrument mismatch involving a third country leading to a deduction without an inclusion;
- a hybrid permanent establishment mismatch, both between Member States and between a Member State and a third country, leading to a double deduction;

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<sup>7</sup> At the time the survey was conducted.

- a hybrid permanent establishment mismatch, both between Member States and between a Member State and a third country, leading to a deduction without an inclusion;
- a hybrid permanent establishment mismatch, both between Member States and between a Member State and a third country, leading to non-taxation without inclusion;
- a hybrid transfer, both between Member States and between a Member State and a third country, where the return on a financial instrument is regarded as derived simultaneously by two jurisdictions, leading to a deduction without an inclusion<sup>8</sup>;
- a hybrid transfer, both between Member States and between a Member State and a third country, where the return on a financial instrument is regarded as derived simultaneously by two jurisdictions, leading to a double tax credit<sup>9</sup>;
- an imported mismatch where a double deduction is imported by a Member State through a non-hybrid instrument;
- an imported mismatch where a deduction without an inclusion is imported by a Member State through a non-hybrid instrument;
- a dual resident mismatch between a Member State and a third country leading to a double deduction.

This proposal carefully pursues the hybrid mismatch arrangements identified in the OECD report. However, it 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, the proposal 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.

## Impacts

Implementation of the proposal for a Directive would deprive MNEs of a widespread aggressive tax planning technique. Therefore, it can be expected that the corporate income tax (CIT) bases in Member States will increase. This would have a positive effect on CIT revenues. Nevertheless, as also stated by the OECD<sup>10</sup>, an economic analysis of hybrid mismatch arrangements requires detailed company-level data. It requires not only information on transactions between associated enterprises but also on the tax treatment of those transactions in the various jurisdictions involved. This kind of data can hardly be found in public sources. Those data would only become available if tax administrations were to make extra efforts to identify hybrid mismatch arrangements, including requesting additional information from taxpayers.

Moreover, it might be difficult to measure those fiscal effects as revenues would not be expected to come from disallowed deductions or disallowed exemptions under the hybrid mismatch rules themselves. Revenues would rather come from MNEs dismantling structures that were intended to exploit mismatches; MNEs would thus no longer claim deductions or benefit from exempt income arising under a hybrid mismatch scheme.

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<sup>8</sup> For example through a sale and repurchase agreement (repo).

<sup>9</sup> For example through a securities lending agreement.

<sup>10</sup> OECD (2015), *o.c.*, p. 224-225.

## References

European Commission (2016) Commission Staff Working Document of 28.1.2016 Communication from the Commission to the European Parliament and the Council – Anti Tax Avoidance Package: Next Steps towards delivering effective taxation and greater tax transparency in the EU {COM(2016) 23 final}

OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

OECD (2016), *Discussion draft on branch mismatch structures under Action 2 of the BEPS Action Plan*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

OECD (2015), *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

Ramboll Management Consulting and Corit Advisory (2016), *Study on Structures of Aggressive Tax Planning and Indicators*, European Commission Taxation Paper, 61.



## Annex I

### Hybrid mismatch structures

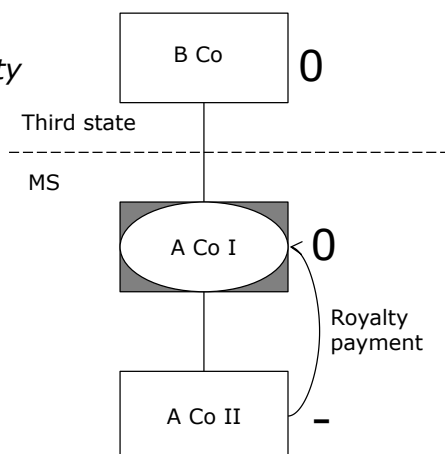
#### Hybrid entity deduction without inclusion

*A Co I is transparent in the MS, but regarded as non-transparent by the third state (reverse hybrid entity).*

*Royalty payment to a reverse hybrid entity in the MS (A Co I).*

*Payment deducted by A Co II.*

*Neither included by A Co I nor by B Co.*



#### Hybrid entity deduction without inclusion II

*C Co is a taxpayer in MS II.*

*B LP is transparent in MS I, so no taxpayer.*

*B LP is regarded as non-transparent by Third State.*

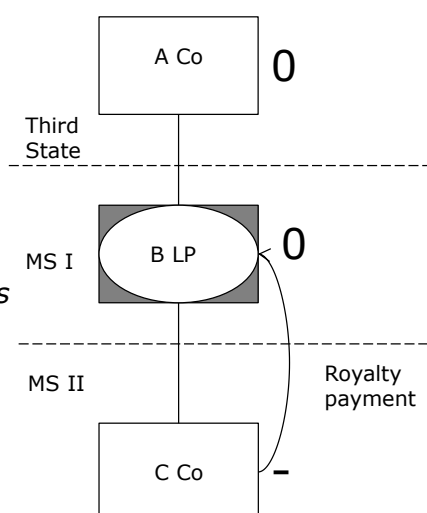
*Royalty payment deducted by C Co, neither included by B LP nor A Co.*

*Both B LP and A Co are associated enterprises of the taxpayer (which is C Co).*

*Deduction without inclusion between MS II and 3<sup>rd</sup> State.*

*No mismatch between MS I and MS II.*

*Mismatch between MS I and Third State is out of scope because B LP is not a taxpayer.*



## Reverse hybrid permanent establishment: no taxation without inclusion

*Reverse hybrid PE in a Third State:*

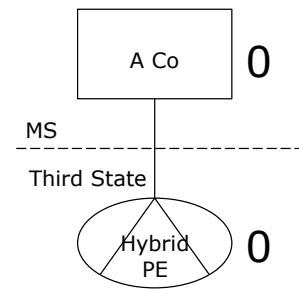
*Third State does not see a PE.*

*MS recognises PE in Third State*

*(reverse hybrid PE).*

*Profits attributed to reverse  
hybrid PE are exempt in MS.*

*No taxation without inclusion  
as a result of a hybrid PE mismatch.*



## Annex 2

### Hybrid mismatch cases in the Aggressive Tax Planning Study

<b>Hybrid loan ATP structure</b>  (based on a model identified in an OECD report)	The structure takes advantage of the hybrid mismatch in qualification of a financing instrument. It benefits from a deduction of the payment in one MS (e.g. as interest) in combination with no inclusion in another MS (e.g. as tax-free dividend). By inserting an intermediate company resident in a third country, this structure still allows to benefit from a hybrid mismatch.
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#### Structure 1 - Hybrid loan ATP structure

This ATP structure is a variation of an example presented in the OECD BEPS reports.<sup>11</sup> The publicly available literature identified that addresses this structure includes “Neutralising the Effects of Hybrid Mismatch Arrangements”, pp. 33-34 (OECD, Action 2: 2014 Deliverable). This structure describes a debt-shifting ATP channel.

The ATP structure takes into account the revision of the Parent/Subsidiary Directive.<sup>12</sup> This ATP structure takes advantage of the hybrid mismatch in the qualification of a financing instrument. Accordingly, the ATP structure benefits from a deduction of the payment in one MS (e.g. as interest) in combination with no inclusion in the other MS (e.g. as a tax-free dividend). By inserting an intermediate company resident in a third country, this structure could still allow benefiting from a hybrid mismatch.

#### Introduction

The ATP structure is established in connection with a multinational group’s acquisition of an operating company in MS C, but it is worth observing that in many situations, it could also have been established in an existing MNE group outside the context of an acquisition.

The structure assumes that the MNE group, a multinational parent company headquartered in MS A, has agreed to acquire a profitable operating company, Target Co, resident in MS C. The purchase price is EUR 1,000 million. EUR 400 million is funded by means of funds that the MNE group already has available to it, whereas the remaining EUR 600 million has to be borrowed from an external bank on normal market terms. The structure has two tax objectives<sup>13</sup>:

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<sup>11</sup> Two variations have been devised:

(i) In the OECD example, MNE Group lends the funds to L Holdco. The authors of the study consider it an unnecessary complication that would limit the practical use of the structure to circumstances where the MNE group had other taxable income in Member State L and tax-deductible costs in Member State P. In practice, it would be simpler and more flexible for the funds to be transferred to L Holdco as share capital.  
(ii) The reference to MS L by state B (for Holding) has been replaced. MS L could erroneously be taken to mean Luxembourg.

<sup>12</sup> Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU *on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States*.

<sup>13</sup> In addition to tax objectives, business objectives often play a significant role.

Firstly, it aims to obtain tax relief in MS C for the external financing costs of the acquisition. This objective should not in itself generally be considered aggressive, as it normally just seeks to align the location of the tax deduction for the external financing costs with the location of the taxation of the profits of the acquired company. Therefore, it does not lead to any undue tax benefit for the MNE group.<sup>14</sup>

Secondly, the structure aims to obtain additional tax relief for *internal (artificially created) financing costs* which do not reflect any external financing costs of the MNE group. This is achieved by means of a hybrid loan that produces an additional tax deduction for interest in the hands of the borrower company in MS C, but triggers no taxation of the corresponding income in the hands of any other member company of the MNE group (nor by any external lender). Clearly, given the exploitation of a mismatch in tax treatment as well as the artificial nature of the hybrid loan, this is the element that makes it an ATP structure.

### **The mechanisms of the structure**

The ATP structure is established by means of the following transactions:

- (1) A holding company, B Holdco, is established in State B – a state outside of the EU – as a wholly-owned subsidiary of the MNE group. The MNE group subscribes to a share capital in B Holdco of EUR 400 million.
- (2) A holding company, C Holdco, is established in MS C as a wholly-owned subsidiary of B Holdco. B Holdco subscribes only to a nominal (minimal) share capital in C Holdco. In addition, C Holdco takes out a loan from B Holdco in the amount of EUR 400 million. The loan is structured on such hybrid terms and conditions<sup>15</sup> that for local tax purposes, State B qualifies the loan as an investment in shares whereas MS C qualifies it as debt. As a result, MS C allows a tax deduction for the interest accrued (or paid); whereas State B does not tax the interest received but instead treats it as a tax-exempt dividend from a shareholding.
- (3) C Holdco takes out an interest-bearing loan from an external bank in the amount of EUR 600 million. The loan is obtained on normal market terms and conditions, backed by a guarantee issued by the MNE group. C Holdco pays a guarantee fee to MNE Group.
- (4) C Holdco enters into a share purchase agreement with the sellers of the shares in Target Co and pays the purchase price of EUR 1,000 million.
- (5) Interest on the bank loan is accrued and paid. C Holdco claims a tax deduction in MS C for the interest accrued/paid. (The external bank is taxed on the interest

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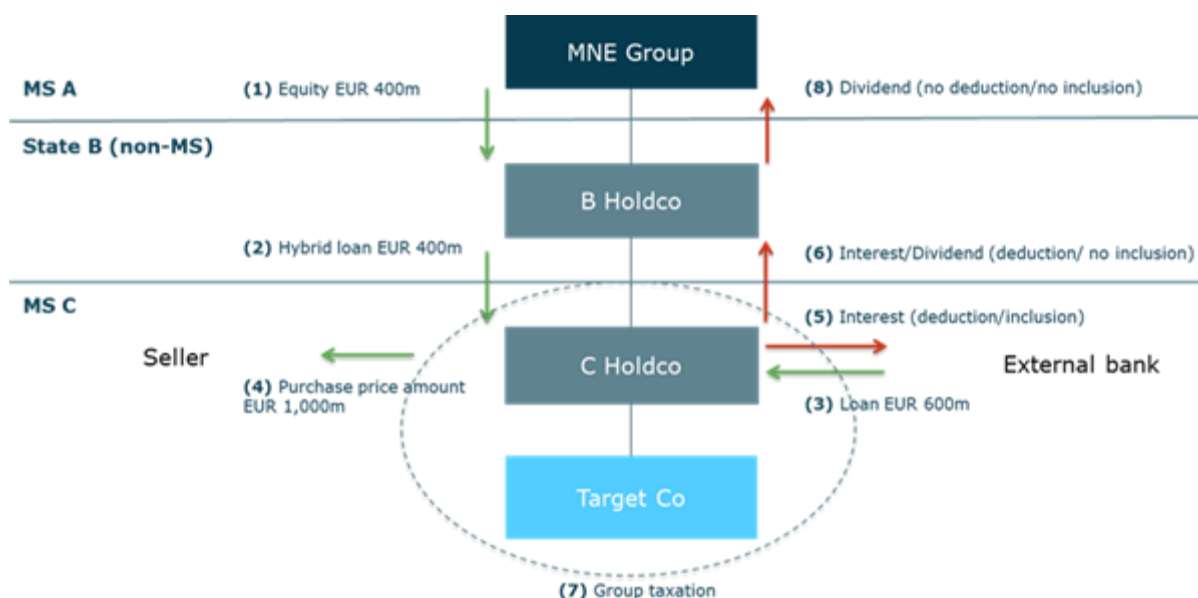
<sup>14</sup> In practice, variations in the MS's tax rules such as different tax rates, different limitation rules on interest deductions, etc., can give rise to some tax benefits - or even tax disadvantages - for a MNE group. While such issues will normally have to be addressed by MNE groups when considering whether to push down debt into MS C, they are not considered core elements of ATP.

<sup>15</sup> Examples of such terms include perpetuity, super-long maturity, profit participation, optional or mandatory conversion features etc.

income under the normal tax rules of its home Member State<sup>16</sup>.) Also, C Holdco claims a tax deduction for the guarantee fee paid to MNE Group.

- (6) Interest on the hybrid loan from B Holdco is accrued, and C Holdco claims a local tax deduction in MS C for the interest as it accrues. B Holdco is not taxed on the interest income either in State B or in MS C.<sup>17</sup>
- (7) Since C Holdco is a pure holding company with no income-generating activities of its own, the utilization of its tax deductions pertaining to the interest on the bank loan and the hybrid loan has to be achieved by means of a local tax grouping (consolidation) with Target Co.<sup>18</sup> Target Co is assumed to have sufficient taxable profits to shelter the interest deductions of C Holdco.
- (8) To the extent that C Holdco makes actual payment of the interest accruing to B Holdco on the hybrid loan, B Holdco would generate cash that could be used to pay a dividend to MNE Group. Such a dividend would not be taxable in the hands of MNE Group under MS A's tax rules, nor would it be tax-deductible to B Holdco under State B's tax rules. Moreover, it is assumed that State B does not levy any withholding tax on the dividend.

The figure below illustrates the structure.



<sup>16</sup> To keep things simple, it is assumed that MS C does not levy any withholding tax on the interest payments.

<sup>17</sup> Again, it is assumed that MS C does not levy any withholding tax on the payment of interest. Alternatively, a tax treaty between state B and MS C exempts the interest from MS C withholding tax.

<sup>18</sup> If a tax grouping is not possible in MS C, there are alternative arrangements for achieving similar results. These include a downstream merger (C Holdco would merge into Target Co), and a reduction of capital (Target Co would declare a capital reduction payment to C Holdco and receive an interest-bearing loan in - return).

## **Step 1**

MNE Group's equity investment in B Holdco will typically not trigger any direct tax consequences in either MS A or State B. However, there can be an indirect tax consequence to MS A in that the funds might have generated taxable interest or similar return on investment before they were transferred to B Holdco. After their transfer to B Holdco, the investment return will normally only come back to MS A in the form of a tax-exempt dividend. The tax consequences of dividend payments are discussed in further detail below under Step 8<sup>19</sup>.

## **Step 2**

The subsequent use of the proceeds from the capital increase as a hybrid loan from B Holdco to C Holdco would normally not directly trigger any tax consequences in State B or MS C upon issuance of the hybrid instrument. The tax consequences with respect to the yield are discussed below under Step 6.

## **Step 3**

The loan obtained by C Holdco from a third-party bank would typically not directly trigger any tax consequences in MS C upon issuance.

## **Step 4**

The sale of shares by Seller will, as a main rule, be tax-exempt in many MS, assuming that the Seller has been the sole shareholder prior to the sale. The actual receipt of cash payment by the Seller should not trigger any tax consequences. The acquisition of the shares by C Holdco would, as a main rule, not trigger any tax consequences in MS C.

## **Step 5**

The yields on the third-party bank loan, in the form of interest payments, can be assumed to be deductible for tax purposes in most (if not all) MSs. This is a crucial feature in the overall tax benefits of leveraged acquisitions. A number of MSs have introduced tax rules to restrict interest deductions. Some of these rules apply only to interest on inter-company loans, but that can include external loans guaranteed by other member companies of the group. Other rules (e.g. EBITA and EBIT rules) apply to the interest on all loans, including third-party debt.

## **Step 6**

In the ATP structure set out above, the yield on the hybrid loan instrument will take the form of tax-deductible interest in the hands of C Holdco in MS C and tax-exempt dividends in State B in the hands of B Holdco. Such a mismatch can arise because the classification of hybrid instruments largely depends on domestic case law in each state. For example, a mismatch of tax qualification can arise if MS C treats the instrument in accordance with its legal form and maintains the debt classification, while State B views the instrument in accordance with its economic substance and classifies it as equity. Accordingly, in State B the yield constitutes dividend, which falls under the scope of State B's domestic-law participation exemption regime, i.e. it is tax-exempt. As another

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<sup>19</sup> Some MSs impose capital duty or stamp duty with respect to capital increases (e.g. a flat amount plus a low percentage (e.g. 0.6%)) computed on the basis of the nominal value of the capital increase. Such taxes are rare and are therefore not taken into account here.

example, the same result could be obtained via hybrid equity where State B maintains the legal form as equity (certain variations of preference shares) while MS C classifies the instrument in accordance with its economic substance as debt, and accordingly treats the yield as deductible interest payments.

In this ATP structure, it is assumed that State B is not an MS and therefore is not affected by the change of the Parent/Subsidiary Directive<sup>20</sup>.

If B Holdco is the beneficial owner of the yield of the hybrid instrument, the payment of the interest from C Holdco to B Holdco would normally not trigger any withholding tax on the interest in MS C. This could follow either from an applicable double tax treaty between State B and MS C, or from the fact that MS C does not levy any interest withholding tax under its domestic law.

### **Step 7**

To ensure the overall economic benefit of the leveraged acquisition ATP technique, C Holdco should be able to offset the deductible interest payments. Being a holding company, C Holdco is unlikely to generate taxable income on a stand-alone basis. Therefore, the economic benefit is typically ensured by the application of domestic group taxation regimes (also referred to as fiscal unity, tax grouping, group tax relief or joint taxation) through which the interest payments in C Holdco can be offset against the taxable operating profit of Target Co.

### **Step 8**

A dividend payment to the MNE group would normally not trigger any tax consequences in MS A due to the existence of participation exemption type legislation, which will effectively exempt the income from taxation. If a double tax treaty (based on the OECD Model Tax Convention) is in place between MS A and State B, Article 10 of the double tax treaty will normally result in 0% or 5% withholding tax in State B.)

### **Absence of CFC taxation**

Finally, it should be noted that the ATP structure set out above assumes that MS A does not apply any CFC rules to the structure. Generally, if CFC rules exist in MS A, they would normally prevent the ATP structure since MNE Group would be required to include in its own taxable income in MS A the interest (treated as dividend in State B) received by B Holdco on the hybrid loan.<sup>21</sup>

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<sup>20</sup> Council Directive 2014/86/EU.

<sup>21</sup> Of course, this assumes that MS A does not apply the same tax qualification to the hybrid loan as state B.

<b>Hybrid entity ATP structure (based on a model identified in an OECD BEPS report)</b>	The structure relies on allocating interest costs to a company which is considered a taxable entity in the state of incorporation and as a transparent entity for tax purposes in the state of the participants. The structure takes advantage of the hybrid mismatch in qualification of an entity. It results in a tax deduction for interest in one MS without any inclusion of the payment in the other MS.
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## Structure 2 - Hybrid entity ATP structure

This structure is a variation of the OECD example referred to in paragraph 72 of “Neutralising the Effects of Hybrid Mismatch Arrangements: Action 2: 2014 Deliverable”. The structure falls into the debt category.

The ATP structure relies on allocating interest costs to a company which is considered a taxable entity in the state of incorporation, and which at the same time is considered a transparent entity for tax purposes in the state of the participants. Such a mismatch in tax subjectivity is often referred to as a hybrid entity (or rather, in the case at hand it is a *reverse* hybrid). Therefore this ATP structure takes advantage of the hybrid mismatch in the qualification of an entity, which results in a tax deduction for interest in one MS without any inclusion of the payment in the other MS.

### Introduction

The ATP structure is established in connection with a multinational group’s acquisition of an operating company in MS B, but it is worth observing that in many situations, it could also have been established in an existing MNE group outside the context of an acquisition. The structure assumes that MNE Group, a multinational parent company headquartered in State A (MS or non-MS), has agreed to acquire a profitable operating company, Target Co, resident in MS B.

The structure aims to obtain tax relief for *internal (artificially created) financing costs* which do not reflect any external financing costs of the MNE group. This is achieved by means of a hybrid entity in MS B that takes out a loan from the MNE Group in state A. This produces a tax deduction for interest in the hands of the borrower company in MS B without any taxation of the corresponding income in the hands of the MNE group in State A.

This ATP structure can either be a result of: (1) different classification of partnerships for tax purposes in the states involved, or (2) check-the-box rules or similar legislation.

As none of the EU MSs currently have legislation similar to the US check-the-box rules, State A cannot be an EU MS in the second scenario. Thus, State A is considered to be an MS in Scenario 1 and non-MS in Scenario 2.

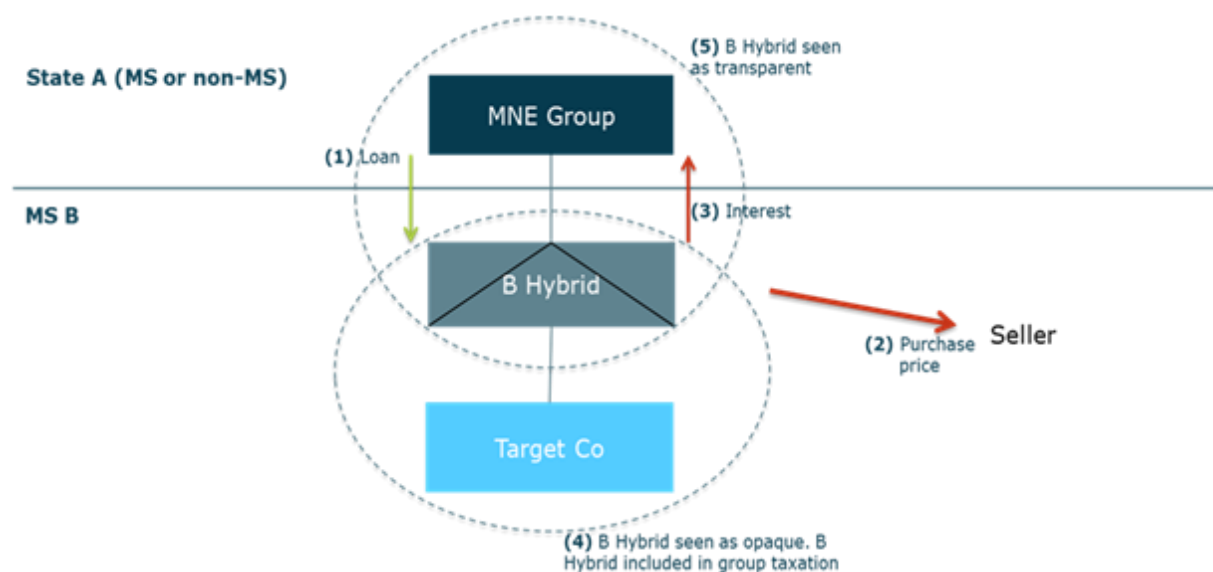
### The mechanisms of the structure

The ATP structure is established by means of the following transactions:



- (1) MNE Group establishes a legal entity, B Hybrid, in MS B. B Hybrid takes out an interest-bearing loan from MNE Group.
- (2) B Hybrid uses the funds borrowed to pay the purchase price for the shares in Target Co and acquires 100% of the shares.
- (3) In its state of incorporation, MS B, B Hybrid is treated as a taxable entity. B Hybrid claims a local tax deduction in MS B for the interest as it accrues.<sup>22</sup>
- (4) Since B Hybrid has no income-generating activities itself, the utilization of its tax deductions for interest on the loan has to be achieved by means of a local tax grouping (consolidation) with Target Co. Target Co is assumed to have sufficient taxable profits to shelter the interest deductions of B Hybrid.
- (5) In the State of its owner, State A, B Hybrid is seen as a transparent entity and is therefore regarded as an integral part of MNE Group. Consequently, the interest income from B Hybrid is seen as stemming from the taxpayer itself and hence is ignored for State A's tax purposes.<sup>23</sup>

The figure below illustrates the structure:



### Discussion of the ATP indicators

Below the factors and characteristics are highlighted which can either facilitate or restrict ATP in the structure set out above. The discussion follows the order of the transactional steps.

<sup>22</sup> It is assumed that MS B does not levy any withholding tax on the payment of interest, either as a result of domestic law, a tax treaty between state A and MS B, or the EU Interest/Royalty Directive.

<sup>23</sup> Alternatively, state A recognises the interest income from B Hybrid, but at the same time a tax deduction is allowed for the interest cost of B Hybrid.

## **Step 1**

In many cases, B Hybrid would be a limited partnership. This would normally require more than one owner, including a limited partner. In such cases, it is assumed that MNE Group would hold the largest possible degree of ownership/profit participation rights in C Hybrid. The granting of the loan by MNE Group to B Hybrid has no tax implications in itself.

## **Step 2**

Payment of the consideration for the shares in Target Co has no tax implications in itself.

## **Step 3**

Interest payments should be deductible for tax purposes in most MSs. This is a crucial feature in the overall tax benefits of leveraged acquisitions. Many MSs have introduced tax rules to restrict interest deductions in cases of so-called thin capitalization. Some of these rules apply only to interest on inter-company loans; other rules (e.g. EBITA and EBIT rules) apply to interest on all loans, including third-party debt. While such restrictions will have to be observed by the MNE group, they may not necessarily work to disallow all interest deductions.

## **Step 4**

Subject to thin-capitalization restrictions, if any, B Hybrid claims a tax deduction in MS B for the interest cost on the loan from MNE Group.

The interest deduction is passed on to Target Co by means of domestic group taxation in MS C (also referred to as fiscal unity, tax grouping, group tax relief or joint taxation). This is a critical factor for the tax benefit of the structure.

It is critical that MS B does not levy any withholding tax on the interest paid to MNE Group in state A. Such exemption from withholding tax may follow either from domestic law, a tax treaty between State A and MS B, or the EU Interest/Royalty Directive.

## **Step 5**

Most MSs apply their own tax qualification of foreign companies and partnerships when determining whether a resident owner (partner) should include the income and cost items of the foreign entity in the taxpayer's local tax return. Typically, such qualification would be based on the same criteria that are applied to domestic entities established/incorporated in that MS. Such qualification is rarely linked to that of the other MSs. Therefore, the qualification of a foreign entity in the owner's MS can differ from that of the entity's MS (state of residence/incorporation).

In the case at hand, it is assumed that State A qualifies B Hybrid as a partnership and hence as a tax-transparent entity. In general, this would normally imply that the owner, MNE Group, will have to include in its own taxable income the income and cost items of B Hybrid. However, most MSs would probably ignore the interest cost and income from the loan between MNE Group and B Hybrid. Either way, in effect there would be no taxation in State A of the interest received from the loan.