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Foreword

The Anti-Tax Avoidance Directives (ATAD), EU Directive 2016/1164 of 12 July 2016 (ATAD 1), as amended by EU Directive 2017/952 (ATAD 2, ATAD and ATAD 2 referred to as ATAD Directives), today represents the backbone of EU legislation enacted to implement the Base Erosion and Profit Shifting (BEPS) Actions set by the OECD and published on 5 October 2015 in order to counteract national tax policies and measures causing such effects.

Due to high fragmentation of EU Member States tax legislations, especially in direct taxation matters, the EU Commission extrapolated some of the BEPS Actions and in 2016 turned such Actions into an anti-abuse (large) package with the aim of introducing a common minimum European framework in significant areas where national legislations were both truly highly fragmented and fragmentation “per se” gave somehow way to tax abuse.

The areas covered by ATAD Directives are:
- the setup of generally accepted anti-avoidance rules;
- deductibility of interest expense;
- controlled foreign company (CFC) legislation;
- exit taxation, i.e. tax rules applicable in the event of migration of companies;
- hybrid mismatches.

It must be noticed that while many, not all, Member States have already adopted internal measures with respect to items from 1 to 4, it is the first time that a specific set of anti-hybrid mismatches rules, item 5, is introduced.

The issue is not new. Starting from the Seoul Declaration of 2006 and going through all the OECD Papers addressing aggressive tax planning, where it was already clear that most of it was based on hybrid mismatches within international complex financial transactions, the reaction from the EU comes after a long time.

However, in the end, it has come.

Within the Taxand network, we thought it would be time to address at least some of the items of the ATAD Directives and decided to focus on finance.

Europe needs foreign investments, so our focus has been appointed on deductibility of interest expense and hybrid mismatches.

The aim is to provide practical, but detailed, guidelines on the interpretation and material application of such two items of the ATAD Directives both to tax practitioners and to international investors.

Especially the latter are sometimes inclined to treat Europe as a single area, where, on the other hand, tax differences are normally very deep among EU Member States in spite of the ongoing push towards higher levels of tax harmonisation and tax coordination.
The further reasons for such a focus are that hybrid mismatch rules are among the less explored items in EU tax law, while interest expense deductibility is by far among the most impacting (thus interesting) tax rules for all kinds of business.

This book will bring focus on each of the two items from two different perspectives, so that for each country the analysis will be mainly twofold (and practically with two separate chapters for each country).

The first kind of analysis (first chapter) will deal with a confrontation between the ATAD EU rules and their execution in national legislations, especially where local Taxand professionals have found relevant discrepancies between the ATAD Directives and the related domestic legislation which executes them. In fact, though ATAD Directives have to be executed and implemented in national legislations separately in each Country and normally EU directives are not directly applicable, local Taxand professionals will provide their comments on whether or not the letter and the spirit of the directives have been duly executed. Thus, the outcome of this analysis will vary accordingly, materially depending on how domestic legislators have interpreted and executed the directives. If they have done “a good job”, this analysis will be very quick and not particularly detailed. If not, it will be the opposite.

The second kind of analysis (second chapter) will deal with an extensive illustration of the new rules as executed in the single domestic legislations, without considering the European perspective. It is clear that when EU norms become domestic norms, they have to be coordinated with the rest of the legislation, so that certain parameters, interpretations and administrative practise is found proper and not in contrast with other local provisions. Thus, our further and final targets are to allow the opportunity to have comparative views of domestic legislations available, the ability to capture the main uncertainties about the application of the law on a country-by-country basis, and, where possible, critical comments and expected potential developments, if any.

ATAD Directives are so recent that no case law is available yet.

Among EU Member States legislations under analysis, we have picked up the following from:
- Italy
- Spain
- Luxembourg
- Germany
- France
- The Netherlands

Finally, thank you to all the national authors who have supported this initiative. We hope this book will help everyone to feel more comfortable in the common home of “Taxanders”.

1. ATAD DIRECTIVES AND THEIR IMPLEMENTATION IN ITALY: AN INTERNATIONAL APPROACH

1.1 BACKGROUND: A BRIEF SUMMARY ABOUT EU LAW INSTITUTIONAL FRAMEWORK

The aim of the present chapter is to analyse ATAD Directives and their implementation from an international tax law approach, more specifically from a EU tax law perspective. The starting point is that EU Court of Justice jurisprudence within the framework of the relationships between EU law and Member States national law in respect of the application of EU Directives, has sensibly evolved.

In the past, the main issue such jurisprudence had addressed was about direct applicability of certain provisions of the EU Directives into national law. The efforts of the Luxembourg Court were the interpretation and analysis of Directives provisions in view of evaluating whether or not such provisions met the qualification of directly applicable norms. Notably, the main conditions of direct applicability of EU Directives were (and are) the following:

1) the terms for the execution of the Directive into national law have expired;
2) the provisions of the Directive are sufficiently detailed and clear so that national law in contrast with them has to be disappplied by domestic courts.

If EU rules are directly applicable, EU citizens and entities are entitled to have their rights protected by national courts directly under such rules, even if domestic rules are in contrast with them.

More recent jurisprudence substantially enriched the principles illustrated above with further issues which confirm the trend by which supremacy of EU law is more and more effective and national law in contrast with EU law has to be disappplied, also in the case where EU rules are not directly applicable.

In various occasions the EU Court of Justice stated that national courts have to evaluate both the letter and also the spirit of a EU Directive in order to ascertain that national law has correctly executed such Directive. In fact, EU law must maintain its supremacy towards national law in any event.

A further recurring and relevant principle is the principle of effectiveness, by which the rights assigned by EU law must be truly effective, i.e. exerting such rights must not be hindered or made excessively difficult by other kind of provisions (procedural, etc.).

1.2 ATAD AND TAXATION OF INTEREST: RATIONALE IN THE INITIAL STATEMENTS

In the foreword it is stated that ATAD Directives were enacted with the purpose of creating a minimum common framework of rules within the EU in order to counteract tax evasion and combat base erosion, thus implementing BEPS. The Directives are applicable only to corporate bodies who are subject to corporate income tax; partnerships and other entities are outside the scope of the Directives.

Within such framework, initial statements of Directive 2016/1164 of 12 July 2016 are, as usual, essential to understand and interpret the rationale and the spirit of the Directive, also according to the EU Court of Justice (the “ECJ”) jurisprudence (in fact initial statements are mentioned many times in the Court rulings in order to ground their conclusions, such as in ECJ -Grand Section 12 July 2005, C -154/05 and C-155/05, Alliance fo Natural Health and National Association of Health Stores; ECJ 30 April 2014, C-280/13, Barclays Bank S.A.).
Initial statement (6) reports that groups of companies may charge excessive interest in order to reduce the tax burden, and such practise must be addressed through a limitation of such deduction to be set at EBITDA parameters.

Initial statement (7) reports that within groups of companies adopting consolidated statements, tax deduction of interest expense may be calculated on the basis of global indebtedness and allow taxpayers to deduct amounts exceeding the ordinary threshold. Initial statement (8) reports that in order to minimise compliance and administrative burdens a “safe harbour” provision may be introduced so that interest expense can be deducted for an amount higher that the ordinary EBITDA threshold.

Furthermore, the “safe harbour” monetary threshold, set at an amount up to €3 million, can be reduced with the aim of protecting the taxable base of Member States can protect the taxable base more effectively.

In fact, art.4, Sec. 3, lett.a) literally reports that the taxpayer may obtain the right to deduct interest expense up to an amount of €3 million.

This leaves Member States with a high degree of flexibility: there is not a fixed amount within the “safe harbour” rule, but an amount “up to”, which implies that any amount within such threshold is legitimate. The crucial point is that the Italian legislator has interpreted the rule as a discretionary and not compulsory one, funding such stand over the word “may” (may obtain the right) reported by art.4, Sec.3.

In other words, the Italian legislator took the stand that the word “may” legitimately allowed the potential choice between implementing or non-implementing the “safe harbour” rule, and subsequently decided not to implement.

In our view the interpretation and execution of such rule by the Italian legislator might not be compliant with EU law.

As a matter of fact, Italy is the only EU Country which did not implement the “safe harbour” rule, while all the other Member States have with different monetary threshold, in perfect compliance with initial statement (8); it is such statement which expressly indicates that, through the reduction of the monetary threshold, Member States can protect the taxable base more effectively.

The “safe harbour” monetary threshold flexibility has been used by all the Member States, except Italy. Some of them introduced the maximum amount of €3 million, some others decided to fix it at €2 million, and so on.

Thus, in our view, a less literal but more substance-oriented interpretation of the Directive might lead to think that the word “may” of art.4, Sec. 3, does not refer to the “safe harbour” rule as a whole, but only to the monetary threshold, which is an essential part of it.

After all, the aim of the “safe harbour” rule is reducing complexity and compliance burdens for, ideally, small and medium size companies, which is a continuous effort of EU policy and does not jeopardize the targets of the Directive.

From another perspective, it seems that the “safe harbour” rule should be seen as part of the minimum common framework within the anti-abuse provisions set forth by the Directive, so, if such minimum framework is not respected, the spirit of the Directive is not complied with.

Member States are allowed to introduce tax rules which can be more restrictive than those introduced by the Directive, but this concept should reasonably have a limit in the need to pursue the targeted minimum common framework within the EU. If the basic rules of the common framework are not respected, then the Directive would lose any relevance.

From the above interpretation it derives that Italy might have failed to properly implement the ATAD Directive since the introduction of the “safe harbour” rule does not seem discretionary but an essential part of the implementation of the Directive.

In the end, since ATAD is aimed at setting up a minimum common framework in the EU, the lack of a common rule as the “safe harbour” in one Member State (Italy) weakens “per se” the whole European set up.
1.4 DEDUCTION OF INTEREST EXPENSE BY COMPANIES: WHAT ABOUT PARTNERSHIPS?

It must be reminded that one of the main features of the ATAD Directives is that they are applicable only to corporate bodies subject to corporate income tax. Partnerships are out of scope, so it is clear that they can benefit from unlimited interest expense deductibility.

According to the EU Commission Recommendation of 6 May 2003 n.361 about the qualification of SMEs (small and medium size enterprises), as executed by the Italian Ministerial Decree of 18 April 2005, the Italian economic environment is substantially made of SMEs together with a large number of micro-enterprises, whose business size and volume of assets is normally below those of SMEs.

This implies that, the number of partnerships, which is the typical form of micro and small size enterprises in Italy, is extremely large. The factual and material effects is that several entrepreneurial activities which are carried on both by partnerships and by companies in direct competition, are that the latter have an economic disadvantage because of ATAD Directives rules on interest expense deductibility.

Though, in our view, such distortion does not create “per se” legal discrimination due to the material differences between partnerships and corporates under general tax law, the question is whether or not, in the framework of addressing tax evasion through charge of excessive interest expense, such difference results rational or irrational.

The trend of our thoughts goes into two directions.

From an EU perspective, according to art. 4, Sec 3, lett. b), independent companies should be left out of the scope of the Directive because no tax evasion can take place in the case of non-intra-group financing, thus independent companies and partnerships, which normally do not belong to groups of companies and do not subsequently give rise to any intra-group financing, should be effectively treated the same way.

The above does not materialize in Italian national tax law, where independent companies are also subject to the 30% EBITDA deductibility threshold, while partnerships are not.

This leads to the irrational result that independent companies and partnerships ideally having the same assets and liabilities size, having the same turnover and performing the same activity, with none of them under the risk of putting in place any abuse of law related to deduction of excessive interest expense, are treated differently.

Again, the above does not seem compliant with the targets and the spirit of the Directive.

In our view, in order to minimize the effects shown above, introducing the “safe harbour” rule would seem the most reasonable solution.

In fact, since partnerships ordinarily manage micro, small and (more rarely) medium size business, willingness to create a level playing field in respect of independent companies and to prevent any form of discriminatory taxation, substantially suggests that the tool offered by ATAD Directive is only the “safe harbour” rule.

If, in the theoretical case shown above, both independent companies and partnerships were both exempted from the application of the 30% EBITDA threshold thanks to a proper “safe harbour” rule, the effects of such an irrational system of taxation as the one in place in Italy now, would be materially reduced.

1.5 CONCLUSIONS

We think that the analysis put in place in previous paragraphs raises some concerns about the proper implementation of the ATAD Directives rules related to interest expense deductibility into the Italian national tax system.

The focus was essentially on the non-implementation by Italy of the “safe harbour” rule as set forth in art.4, Sec. 3, lett. a) of ATAD, which makes the above the only exception among all Member States.

The result of our survey shows how relevant this rule is within the effort to introduce a common EU framework in this area.

In fact, it seems to us that without a safe harbour there is, at first, no potentially possible EU common framework, thus undermining the aims and targets of ATAD Directives and subsequently violating EU Law, and, secondly, the resulting system brings to practical irrational consequences.

In the end, safe harbour rules are an essential part of the common framework set by the ATAD Directives and, in our view, Italy should implement them as all the other EU Member States.
2 ITALIAN IMPLEMENTATION OF THE ATAD INTEREST LIMITATION RULE

2.1 INTRODUCTION

Aggressive tax planning jeopardises one of the principles on which a fair and coordinat-
ed tax system is based, namely ensuring that tax is paid where profits and value are gen-
erated. These new political objectives have been translated by the European Council in
the ATAD Directive1 of 12 July 2016 (ATAD 1), implemented in Italy through the Legislative
Decree n. 142/2018 (D.Lgs. 142/2018).

In this respect, the ATAD 1 lays down rules to strengthen the average level of protection
against aggressive tax planning by providing a set of general provisions in five specific fields, the first of which is the limitation to the deductibility of interests.

Indeed, as reported in the initial statement
(6) – in an effort to reduce their global tax liabilities – groups of companies have increasingly engaged in base erosion and profit shifting practices, through excessive interest payments; to this end, an interest limitation rule was necessary to discourage such practices by limiting the deductibility of taxpayers’ exceeding borrowing costs. In particular, ATAD 1 laid down a minimum standard in the form of a general interest limitation rule based on the EBITDA while the choice has been to modify the rules not in line with effects starting from the 2019.

2.2 GENERAL RULE

According to the new Art. 96, par. 1, interest expenses and other costs economically equivalent to interest (for simplicity “interest expenses”), including those capitalized in the cost of the assets, are deductible in the tax period in which they are incurred up to:

i. the amount of interest revenues and other economically equivalent taxable revenues (for simplicity “interest revenues”) of the year;

ii. the amount of interest revenues carried forward from previous fiscal years, as described later.

Under par. 2, any excess of interest expenses over interest revenues (for simplicity “net interest expenses”) is deductible up to an amount equal to the sum of the 30% of EBITDA of the tax period and the unused 30% EBITDA carried forward from previous years. In this respect, the new law clarifies that the net interest expenses should be, firstly, offset against the 30% EBITDA of the year and, subsequently, against the 30% EBITDA carried forward under the so-called “FIFO” method, namely starting from the least recent.

According to par. 5 – which was not amended by the implementation of the ATAD 1– interest expenses that, in a tax period, exceeds (i) the interest revenues of the year, (ii) the interest revenues carried forward, (iii) the 30% EBITDA of the year and (iv) the 30% EBITDA carried forward (“exceeding interest expenses”), are not deductible in the relevant tax period and are carried forward to the following fiscal years, without any time limit.

Such exceeding interest expenses may, therefore, be deducted in a subsequent fiscal year if and to the extent the sum between the interest revenues and the 30% EBITDA is higher than the interest expenses of that tax period. Par. 6 provides, in an innovative way, that if interest revenues accrued in a tax period exceed the interest expenses (“exceeding interest revenues”), such excess may be carried forward to subsequent tax periods – without any time limit – and can be used to compensate future interest expenses. On the other hand, if – in a tax period – the 30% EBITDA is higher than the net interest expenses (“excess of 30% EBITDA”), such excess can be carried forward for a maximum of five years to offset future exceeding interest expenses. In this respect, it should be highlighted that in the past there was not any time limitation for the carry forward of the excess of 30 EBITDA.

Against this background, it is worth analysing further some of the amendments to the interest limitation rules brought from the implementation of the ATAD Directive.

According to par. 1, as described above, the interest limitation rule now applies also to capitalised interest expenses included in the balance sheet value of a related asset, as expressly provided by Art. 2, par. 1 of the ATAD Directive; this would mean that the deductibility of the interest expenses should be verified in the year of capitalization in the balance sheet, thereby denying the entire or partial deducibility of such interest, without prejudice to the recognition for tax purposes of the depreciations of the value of the assets to which they refer2.

In addition, interest expenses may now be offset not only against the interest revenues of the tax period but also against the excess of interest revenues of the past years carried forward; this rule, even though not expressly provided by the ATAD Directive, is in line with its purposes and is motivated by the fact that – as a consequence of the decision to consider as interest expenses and revenues those that qualify as such on the basis of the accounting principles adopted – there could be situations in which, having regard to a specific transaction, a year may be characterized by an excess of interest revenues and the following ones by exceeding interest expenses.

Consider, for example, the case of taking out an interest-bearing loan with an interest rate lower than the market one which should be measured at fair value; the difference between the prevailing market rate(s) of interest for a similar instrument. This would lead, initially, to the recognition of the day-one profit – which gives rise to an interest income – and, subsequently, to the accounting of the interest expenses at market rate.

2.3 THE DEFINITION OF INTEREST EXPENSES AND REVENUES

Before addressing the specific topic object of this paragraph, it would be useful to provide some general comments on the main characteristics of the “derivation principle” which consists in considering relevant for tax purposes the accounting representations of the different balance sheet and P&L items. Such principle, that is aimed to reduce the discrepancies between the operating profits and the taxable basis, was firstly introduced for the IAS/IFRS adopters but – as a consequence of the redraft of the Italian accounting standards – since 2016 it has been extended to the Italian GAAP adopters, with the exclusion of the micro-enterprises3.

3Explanatory Report to the D.Lgs 142/2018.
4Explanatory Report to the D.Lgs 142/2018.
5According to Art. 2435-ter of the Italian Civil Code micro-enterprises as those that for two consecutive years do not meet two of the following three criteria: (1) averaged hired employees higher than 5; (2) assets of the balance sheet higher than Euro 175k; (3) turnover higher than Euro 350k.
According to the derivation principle, as ruled by Art. 83, par. 1 of the CDTC, in derogation to the general tax principles, the qualification criteria, the time-based recognition and the classification in the financial statements provided by the accounting standards adopted (either Italian GAAP or IAS/IFRS) are relevant for the computation of the tax base:

- the qualification criteria refer to the exact identification of the transactions that have taken place and their effects from an economic, juridical and contractual point of view. These criteria would substitute juridical and formal approach with the substantial;
- the classification criteria are the direct consequence of the identification ones and allow the correct representation in the financial statement of the balance sheet and P&L items;
- time-based recognition refers to the period in which the revenues and expenses become relevant for tax purposes and it is strictly linked to the economic accrual principle.

That being said, Art. 1 of the D.Lgs. 142/2018 substantially amended the definition of interest expenses and revenues. More in particular, under the new par. 3 of Art. 96, which defines the objective scope of the provision, interest expenses and revenues relevant for the purpose of the rule are those that:

i. are accounted as interests according to the applicable accounting principles (Italian GAAP or IAS/IFRS);
ii. their accounting treatment as interest is confirmed by the tax rules; and
iii. arise from transactions or contracts having a financial purpose or incorporating a significant financial component.

In this respect, it is worth noting that the BEPS Actions 4 affirms that the interest limitation rules should be applied not only to interest expenses on all forms of debts but also to other costs economically equivalent to interest, having to ascertain the equivalence on the basis of the economic substance rather than the legal form. For that reason, bearing in mind that the accounting representation based on the substance over form principle applies to both the financial statements under the Italian GAAP and the IFRS, it was decided to limit the objective scope of the rule to the interest expenses and revenues that qualify as such under the accounting principles and for which the qualification is confirmed from a tax standpoint.

Therefore, from a procedural point of view, it should be firstly determined whether a specific item qualifies as interest from an accounting point of view, then verify if such qualification is not denied from a tax perspective and, lastly, ascertain that such interests refer to a financial transaction or a contract with a significant financial component.

As far as point i) is concerned, under the Italian GAAP nor IAS/IFRS provide a clear definition of interest expenses and revenues. The Italian GAAP n. 12 provides a non-exhaustive list of items of the P&L account that should be treated as such. However, several circumstances from other accounting principle may give rise to revenues and expenses that should be assimilated to interest, such as:

a. fees, transaction costs and other premiums or discounts that adjusts the contractual interest rate on the basis of the amortised cost method provided by Italian GAAP 19, par. 45 and IFRS 9, par. B 5.4.4;

b. higher or lower interests deriving from the discounting of financial liabilities granted at an interest rate considerably different to the market one (Italian GAAP 19, par. 50 and IFRS 9, par. B 5.3).

On the other hand, some doubts may arise with regards to the qualification of other elements.

For example, as already pointed out, a financial asset/liability with an interest rate lower than the market one should be measured at fair value discounted by using the prevailing interest market rate. This would lead to a recognition of the day-one profit/loss that should be accounted as financial income/expenses, unless from the substance of the transaction it may be concluded that such component has a different nature. In principle, the day-one profit/loss booked as a financial component at initial recognition should be qualified as interest expenses/revenues from the purposes of Art. 96 of the CDTC, because linked to higher/lower interests that will be booked in the future in the P&L account. However, if the day-one profit/loss did not have a financing nature, the result would be different.

Under par. 3.3.2. of the IFRS 9, the exchange, between an existing borrower and lender, of debt instruments with substantially different terms shall be accounted as an extinguishment of the original financial liability and a recognition of a new one. In such a case, under par. 3.3.3. “the difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss”.

In this respect, according to prominent scholars, the profit or loss deriving from the extinguishment of the financial liability should be treated for accounting purposes as a “realized income/loss” and, therefore, taxed as an extraordinary income or a receivable write-off, with the result of being excluded from the scope of the interest limitation rule.

On the other hand, under par. B3.3.6 of IFRS 9, in case of a “non-substantial” exchange or modification of a debt instrument which does not trigger a derecognition event, any costs or fees incurred should adjust the carrying amount of the liability with the subsequent modification of the effective interest rate. In addition, the modifications of the contractual cash flows deriving from renegotiation of the financial liability should not revise the effective interest rate but should be recognised in the P&L as income or expense. Therefore, in principle, the first should fall within the scope of Art. 96 and the latter should not be subject to the interest limitation rules.

Another example are the components related to a hedge contract having as hedged item a financial instrument that should fall within the definition of interest for accounting purposes because – in the P&L accounts – they offset the interests deriving from the hedged financial instrument. On the other hand, the component that is hedge ineffectiveness should not fall within the definition of interest, lacking the economic relationship between the hedged item and hedging instrument. Indeed, in general, when the hedging instrument is not totally hedge effectiveness, because, for example, its quantity is higher than hedged item, the exceeding amount should not be booked as hedging instrument, with the result that the cash flows arising from it would not qualify as interest lacking the link with the entity’s borrowings.

Having determined the accounting qualification, it should be verified whether such qualification is also confirmed for tax purposes.
This analysis, for example, would lead to the result that the following items would be excluded from the scope of the rule:

a. interest deriving from the application of the amortized cost method to the financial instruments issued by micro-enterprises, as defined in Art. 2435-ter of the Italian Civil Code, because for such companies the derivation principle is not applicable;

b. interest from repurchase agreements of stocks14;

c. interest from the discounting of liabilities of uncertain amount15;

d. interest from the discounting of free interest-bearing loans between associated enterprises that at initial recognition must be booked as an increase of the net equity (for the borrower) and an increase of the cost of the participations (for the lender)16.

Finally, the interest must be incurred in connection with raising of finance or from contracts with a significant financing component. In this respect, the clarifications given by the Italian Tax Authorities in the Circular Letter 21 April 2009 n. 19 are still valid, where it is stated that the rule is applicable to i) “any and all interest (or similar expense) incurred in connection with the raising of finance or the making available of financial instruments or other assets for which there is a repayment obligation and which provide a specific remuneration” and ii) “any revenue, expenses or positive/negative item of income which under a substance over form approach should be assimilated to an income which under a substance over form approach should be assimilated to an income”.

Even though the new Art. 96 does not contain any more a list of transactions of financing nature, the rule is still applicable for interest derived from loans, financial leasing contracts and interest for late payment, severance packages (TFR), the timing value of the call/put options and forward contracts and interest for late payment should be excluded from the scope of the rule lacking the financing element, namely the raising of finance with a repayment obligation18.

Having said that, the new par. 3 of Art. 96 specifies that interest revenues are relevant for the purposes of the rule in so far as they are taxable. For example, in case of participating bonds, namely those that provide the holder with dividends as well as interest, the amount of the income that qualifies as dividend and may benefit of the participation exemption regime would be excluded from the scope of the rule19.

In addition, it is specified that regardless the accounting treatment as equity instrument – proceeds that are fully taxable in the hands of the recipient are included in the definition of interest income. For example, proceeds from equity instruments that are deductible in the hands of the issuer (such as the Brazilian Juros Sobre or Capital Proprio) are fully taxable in the hands of the recipient – under art. 44, par. 2, let. A) of the CDTC – and, therefore, are included in the definition of interest income20.

Even though the Explanatory Report to the D.Lgs 142/2018 makes only reference to equity instruments issued by non-resident persons, it is believed that the Italian legislator wanted to align the objective scope of Art. 96 with the fiscal definition of instruments similar to shares21 and similar to bonds22 – as provided by Art. 44, par. 2 – which cannot be derogated by the classifications provided by the accounting principles adopted23.

Therefore, a financial instrument is booked in the balance sheet as equity but it does not fulfill the requirements to be treated for tax purposes as “similar to shares” – because its return is not entirely made up by the participation to the economic results of the issuer – the remuneration derived from such instrument will qualify as interest revenue for Art. 96 purposes to the extent that is taxable in the hands of the recipient.

Similarly, an IAS/IFRS adopter that issues perpetual bonds – that do not have a maturity period and provide a discretionel payment of coupons – should treat them – for accounting purposes – as an equity instrument. Consequently, the coupon payments will not be booked in the P&L accounts but will reduce the net equity of the issuer. From a tax perspective, the perpetual bond will not be qualified as “similar to shares”, with the result that the coupon payments – even though not booked as interest – should qualify as such and, therefore, should fall within the scope of Art. 9624.

2.4 THE DETERMINATION OF THE EBITDA

Art. 96, par. 4 provides the definition of EBITDA bringing it in line with the provisions of the ATAD Directive. The starting point is the computation of the operating earnings, namely the difference between revenues and expenses that are directly associated with the operating business, to which depreciations, amortization and financial leasing costs must be excluded.

12 According to art. 44, par. 2 of ITC, similar to bonds are defined as “mass securities containing the unconditional obligation to pay, at maturity, a sum certain, that is not less than the nominal value indicated in them, with or without the payment of a periodic remuneration, which do not confer upon the holder any direct or indirect management right relating to the issuer or the deal relating to which the security was issued, and which give any control over the management itself”.
14 According to art. 5, par. 2 of the Ministerial Decree 8 June 2011 and Art. 109, par. 4 of the ITC remunerations of financial instruments similar to bonds could be booked even though not booked in the P&L accounts but in reduction of the net equity.
15 More in particular, under Art. 96 EBITDA shall be the difference between the “value of production” (ist. A of Art. 2525 of the Italian Civil Code and the “cost of production” (ist. B of Art. 2525), except amortization and depreciation of tangible and intangible assets and payments from financial lease.
16 More in particular, under Art. 96 EBITDA shall be the difference between the “value of production” (ist. A of Art. 2525 of the Italian Civil Code and the “cost of production” (ist. B of Art. 2525), except amortization and depreciation of tangible and intangible assets and payments from financial lease.
17 More in particular, under Art. 96 EBITDA shall be the difference between the “value of production” (ist. A of Art. 2525 of the Italian Civil Code and the “cost of production” (ist. B of Art. 2525), except amortization and depreciation of tangible and intangible assets and payments from financial lease.
18 According to art. 44, par. 2 of ITC, similar to bonds are defined as “mass securities containing the unconditional obligation to pay, at maturity, a sum certain, that is not less than the nominal value indicated in them, with or without the payment of a periodic remuneration, which do not confer upon the holder any direct or indirect management right relating to the issuer or the deal relating to which the security was issued, and which give any control over the management itself”.
19 Ibid.
20 According to art. 44, par. 2 of the ITC, similar to shares means a financial instrument issued by a company or an entity having a main commercial purpose, whose return is entirely made up by a participation (a) to the economic results of the issuer or (b) the economic results of another company of the same group or (c) the economic result of a single deal relating to which the securities or the financial instruments were issued; in the case of non-resident issuers, it is also required that the said remuneration paid is entirely non-deductible in the country of residence of the issuer.
it is stated that IAS/IFRS adopters must consider the corresponding items of their P&L accounts28.

In the past, the literal wording of the provision limited the field of “research” only to the items of the P&L accounts, without considering those booked in the other comprehensive income (OCI) or in the net equity. With the new provisions – as a consequence of the introduction of the tax-adjusted EBITDA – the field of research must be extended29. Therefore, for example, the costs related to severance packages (TFR) should include the interest costs (booked in the financial expenses) and the actuarial gain and losses (booked in the OCI)29.

In addition, as far as tax allowances is concerned, their relevance for EBITDA purposes will depend on whether such allowance is linked to a specific item of income or it qualifies as a general deduction not linked to any specific income:

• in the first case, such as the branch exemption regime, the income excluded from taxation will reduce the EBITDA;
• in the second case, for example in case of “allowance for corporate equity”, the deduction will not have any impact on the EBITDA.

Finally, some scholars are of the opinion30 that, in case of a tax audit, the higher taxable basis as a consequence, for example, of a challenge on the deductibility of certain operating expenses, could be reduced by the higher deduction of interest expenses deriving from the higher tax-adjusted EBITDA of that fiscal year. This because, in the view of restoring the situation that would have been verified ab origine if the taxpayer had not deducted such cost, such non-deductible cost – if relevant for EBITDA purposes – would have increased the tax-adjusted EBITDA amount.

2.5 THE EXCLUSION OF PROJECT FINANCING

With the new Art. 96, the interest limitation rules for project operators have been amended through the introduction of an “objective” exclusion. Indeed, the previous rule, based on a “subjective” exclusion, was not in line with the provisions of the ATAD Directive.

In particular, a first version of the new Art. 96, paragraphs 8-11 of the CDTCL, as amended by the D.Lgs. 142/2018, excluded from the scope of the rule the interest expenses incurred on loans used to fund a long-term public infrastructure project (LTPIP) provided that:

a) such loans were secured by neither (i) the assets that belonged to the operator and did not concern the same LTPIP nor (ii) by other persons different from the operator. In other terms, the project should have been secured only by assets that belonged to the operator and concerned the same LTPIP;

b) the LTPIP operator was tax resident in a Member State of the European Union; and

c) the assets used for the realization of the project and the assets constituting the object of the LTPIP were located in a Member State of the European Union.

With regard to point a), it is worth noting that in case of SPV set up exclusively for the construction and management of the LTPIP, it is a general accepted market practice the inclusion in the so called security package of the pledge of the SPV’s shares or the assignment, as collateral, of the shareholder loans granted to the SPV31.

In these circumstances, the new requirements precluded the applicability of the exclusion rule because the loans were guaranteed by assets not belonging to the operator.

For such reason, with Art. 35 of the D.L. 26 October 2019, n. 124, the Italian legislator – without changing the requirement sub c) and c) – modified the Art. 96 by providing that the operators, characterized by a segregated asset regime in respect of the other assets, and liabilities not related to the LTPI, can fully deduct the interest expenses even though the loans are secured by additional forms of guarantee.

In addition, the new article provides that if the LTPIP constitutes a “separate estate” in respect of the other assets and liabilities of the operator – namely is characterized by a segregated asset regime – or it is established that the loan is refunded exclusively with the positive cash flows generated by the LTPIP, the interest expenses excluded from the scope of Art. 96 are those that accrues on the “segregated estate” or that are exclusively destined to the LTPIP.

In the other cases, the interest expenses excluded from the limitation regime should be determined by multiplying the total amount of interest by the proportion between the amount of revenues (and increases in the inventory and work in progress) related to the LTPIP and the total amount of revenues (and increases in the inventory and work in progress).

Finally, it is stated that if some of the interest expenses fall within the cause of exclusion, the tax-adjusted EBITDA should be determined without considering income and expenses related to the LTPIP.

2.6 DEDUCTIBILITY OF INTEREST EXPENSES IN CASE OF TAX CONSOLIDATION

Par. 14 of Art. 96 has been redrafted in order to allow – in case of tax consolidation – the offsetting of the exceeding interest expenses incurred by a company with both the exceeding interest revenues and the excess of 30% EBITDA of other companies of the tax group.

More in particular, exceeding interest expenses incurred by one company in a period of tax consolidation may be offset against (i) the exceeding interest revenues of other companies of the tax group accrued in that period, (ii) carried forward exceeding interest revenues of other companies of the tax group accrued in that period, (iii) excess of 30% EBITDA of other companies of the tax group generated in that period, (iv) carried forward excess of 30% EBITDA of other companies of the tax group generated in a period in which the tax consolidation was in place, and (v) by other companies of the tax group accrued in a period in which the tax consolidation was in place.

In other terms, the computation of the non-deductible interest is performed at the level of the single entity but the amount, in principle, not deductible on a stand-alone basis may be transferred to the consolidating entity and deducted if and to the extent another company has exceeding interest revenues or an excess of 30% EBITDA.

2.7 REAL ESTATE COMPANY

Two rules contained in the Budget Law 200832 regulate the deductibility of interest expenses in case of companies operating in the real estate market.

More in particular, Art. 1, par. 35 of the Budget Law 2008 provides that “the expenses and other costs that are non-deductible, under par. 2 Article 90 of the Presidential Decree n. 917 of 22 December 1986, do not include interest expenses relating to loans for the acquisition of the real estate listed in paragraph 1 of Article 90”.

28 Ibid
29 Explanatory Report to the D.Lgs 142/2018.
It is worth noting that Art. 90, par. 2 of the CDTC provides that the expenses – related to immovable properties that are neither instrumental assets for the purposes of the business nor assets the production or the transfer of which is the business activity of the company – are not deductible. Against this rule, the authentic rule of interpretation provided in the Budget Law 2008 clarified that the loans for the acquisition of the immovable properties listed in Art. 90 does not fall within the non-deductibility provision and, therefore, must be subject to the ordinary interest limitation provision of Art. 96. In this respect, the ITA has also clarified that exclusion rule is not limited to the interest expenses related to the purchase of the real estate asset but also to those incurred for its construction, leaving the applicability of Art. 90, par. 2 only to the interest expenses incurred for the functioning of the business.

On the other hand, Art. 1, par. 36 of the Budget Law 2008 states that interest expenses related to loans secured by mortgages on properties held to be rented are not relevant for the purposes of Art. 96 of the CDTC and are, therefore, fully deductible.

At that time, the provision was a transitional rule that should have produced effects until the implementation of a new system of rules aimed at the simplification and rationalization of the existing direct and indirect tax system for real estate companies. However, given the failure to introduce such new set of rules, the provision has been perceived as final33.

Briefly, the rule – as amended by the D.Lgs. 14 September 2015, n. 147 – provides that:

i. it applies for companies which are effectively and principally engaged in real estate activities, namely those that – at the end of the relevant tax period – have balance sheets assets constituted for the most part of their market value34 by immovable property to be rented out and with at least two thirds of revenue constituted by proceeds from the lease of property or business whose aggregate value mainly consists of the market value of buildings;

ii. the interest expenses should relate to mortgage loan for the purchase or construction of immovable properties held to be rented;

iii. the mortgage should relate to the same property held to be rented;

iv. the rent may also occur after the acquisition of the property but, in any case, should be proved based on objective elements (such as BoD resolutions)35;

v. it applies also to the re-financing for the amount that does not exceed the original loan taken out to purchase the real estate asset.

Against this background, it should be pointed out that the “new” Art. 96 – as amended by the draft Legislative Decree 142/2018, approved by the Council of Minister on 8 august 2018, – neither proposed a revival of the provisions contained in Art. 1, par. 36 of the Budget Law 2008 nor its repeal. For that reason, in the first instance, it was believed that the rule was still applicable because if the intention was to abolish it, it should have been done explicitly.

In this respect, the 6th Senate Finance Committee suggested the Italian government to extend the applicability of Art. 96 also to interest expenses related to loans secured by mortgages on properties held to be rented by real estate companies. The Italian Government accepted the proposal and in the final draft of the D.Lgs. 142/2018 introduced Art. 14, par. 2 which provided the repeal of Art. 1, par. 36.

However, this decision has been criticized by the trade associations due to the tightening of the taxation of the real estate companies for which the amendment would have led to a higher taxation of 5 percentage points. The requests of the trade associations have been accepted by Italian government that with the Budget Law 201936 repealed Art. 14, par. 2 of the D.Lgs. 142/2018 and confirmed the application of provisions contained in Art. 1, par. 36 of the Budget Law 2008.

Having said that, some scholars37 questioned about the compatibility of the aforementioned provision with the ATA Directive which do not contain derogation for real estate companies. In this respect, it is worth noting that the interest limitation rules provided by Art. 4 of the ATAD 1 represent a minimum standard to which each Country should comply with in the execution and implementation of the Directive in the national legislation, taking into account the peculiarities of its national tax system. In addition, the ATAD 1 also allows, by derogation of the general rule, the taxpayer to deduct net interest expenses for an amount higher than the 30% EBITDA, in circumstances where the risk of base erosion and profits shifting is lower38.

In the light of the above, considering that – in general – the indebtedness of real estate companies does not give rise to risks of tax evasion, the exclusion under analysis should not be read as in contrast with the ATAD 1 but as a provision aimed to ensure the financial stability of real estate companies. Indeed, for these companies that borrows money – for the acquisition of immovable properties to be rented – at an interest rate just below the rental charges, the interest non-deductibility may result in uneconomical business39.

In the same way, ATAD 1 recognized that although it is generally accepted that financial undertakings should also be subject to limitations to the deductibility of interest, it is equally acknowledged that these two sectors present special features which need a more customised approach. For such reason, ATAD 1 concluded that, since discussions in this field are not yet sufficiently conclusive in the international and Union context, it is not yet possible to provide specific rules in the financial and insurance sectors and Member States should therefore be able to exclude them from the scope of interest limitation rules40.

2.8 BANKS AND INSURANCE COMPANIES

With regard to the possibility of using interest expenses for base erosion practices, the OECD, firstly, recognized in the BEPS Action 4 that the general interest limitation rule is unlikely to be effective in addressing concerns related to banks and insurance companies and, secondly, recommended that each country should identify the specific risks, taking into consideration the characteristics of the industry and the regulatory requirements. If no risks are identified, companies of such sectors can be excluded from the general limitation rule; on the other hand, if certain risks are identified, the countries should address such risks through appropriate rules, also considering the applicable regulatory regime and tax system41.

In the same way, ATAD 1 recognized that although it is generally accepted that financial undertakings should also be subject to limitations to the deductibility of interest, it is equally acknowledged that these two sectors present special features which need a more customised approach. For such reason, ATAD 1 concluded that, since discussions in this field are not yet sufficiently conclusive in the international and Union context, it is not yet possible to provide specific rules in the financial and insurance sectors and Member States should therefore be able to exclude them from the scope of interest limitation rules42.

In the light of the above, it is worth noting that the implementation of the ATAD 1 in the Italian legislation did not have any impact on the interest limitation rules for banks and insurance companies.

33 Assonime Circular Letter, 18 November 2009, n. 46.
34 ITA Circular Letter 4 August 2008, n. 36.
36 Law 30 December 2018, n. 145.
38 Par. 3, of Art. 4 of the ATAD 1 provides that: “By derogation from paragraph I, the taxpayer may be given the right: (a) to deduct exceeding borrowing costs up to EUR 3 000 000; (b) to fully deduct exceeding borrowing costs if the taxpayer is a standalone entity. For the purposes of the second subparagraph of paragraph I, the amount of EUR 3 000 000 shall be considered for the entire group”.
41 Ibid.
42 Initial statement (9) of the ATAD 1.
Indeed, the Italian government exercised the option to exclude financial intermediaries, insurance companies and parent companies of insurance groups from the scope of the general interest limitation rule. At the same time and in line with the previous rule, Art. 96, par. 13 of the CDTC provides that insurance companies, parent companies of insurance groups, asset management companies and qualifying brokerage companies can deduct interest expenses only up to 96% of the amount. On the other hand, financial intermediaries can fully deduct interest expenses.

In this respect, it is worth noting that the new provision should be coordinated with the new definitions of financial intermediaries, as provided by art. 162-bis of the CDTC. In particular, the following definitions have been clarified:

a) financial intermediaries:
   i. the entities referred to in art. 2, paragraph 1, letter c), Legislative Decree 28 February 2005, no. 384 and entities with a permanent establishment in the territory of the State having the same characteristics;
   ii. the credit consortia (confidi) registered in the list indicated in art. 112-bis, Legislative Decree 1 September 1993, no. 385;
   iii. the microcredit operators registered on the list referred to in art. 111, Legislative Decree no. 385;
   iv. the entities that exclusively or prevalently carry out the acquisition of shareholdings in financial intermediaries, other than those referred to in number 1);

b) financial holding companies: the entities that exclusively or prevalently carry out the acquisition of shareholdings in financial intermediaries;

c) non-financial holding companies and similar:
   i. the entities that exclusively or prevalently carry out the acquisition of shareholdings in entities other than financial intermediaries;
   ii. the entities that perform activities that are not directed towards the public, pursuant to art. 3, paragraph 2, of the regulation issued on the subject of financial intermediaries to implement articles 106, paragraph 3, 112, paragraph 3 and 114 of Legislative Decree no. 385, cited above, as well as art. 7-ter, paragraph 1-bis, Law 30 April 1999, no. 130.

As regards hybrid mismatches, the objective of ATAD is to implement the OECD recommendations in the EU Member States in a coordinated way. Under the anti-hybrid rules, in order to avoid double non-taxation derived by hybrid mismatches, Member States 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.

This section analyses the Italian Anti-Hybrid Rules illustrating the scope (paragraph 3.1), the rules (paragraph 3.2), the exclusions (paragraph 3.3), the role of Italy in their application (paragraph 3.4), the hybrid mismatches covered (paragraph 3.5), the impact on investment funds (paragraph 3.6) and providing for some conclusions (paragraph 3.7).
3.1 SCOPE OF ITALIAN ANTI-HYBRID RULES

Italian Anti-Hybrid Rules introduced by ATAD Implementing Decree apply to the extent their subjective, objective and territorial requirements are met.

SUBJECTIVE SCOPE

Article 6(1)(t) of ATAD Implementing Decree provides that anti-hybrid rules apply to taxpayers subject to income tax in Italy on their business income (Italian Taxpayer).

In particular, they apply to:
• resident companies;
• resident entities carrying out business activities;
• permanent establishments located in Italy of non-resident companies or entities;
• resident partnerships carrying out business activities;
• individuals carrying out business activities.

It has to be pointed out that the scope of the Italian Anti-Hybrid Rules is broader than the one of the ATAD, the latter being applicable only to taxpayers that are subject to corporate income tax in a Member State. Indeed, Italian Anti-Hybrid Rules cover all taxpayers subject to income tax in Italy on their business income, including individuals. The explanatory report of ATAD Implementing Decree highlights that the rationale behind such extension is due to the fact that anti-tax avoidance rules introduced in Italy (e.g. general anti-abuse rule and CFC rule) apply to all Italian taxpayers deriving business income, while according to ATAD the general anti-abuse rule and CFC rule apply only to taxpayers subject to corporate income tax in a Member State. In any case, the extended scope of Italian Anti-Hybrid Rules seems compliant with article 3 of ATAD, which provides that the directive shall not preclude the application of domestic provisions aimed at safeguarding a higher level of protection for domestic corporate tax bases.

ARTICLE 6(2)(c) OF THE ATAD IMPLEMENTING DECREES LIMITS THE SUBJECTIVE SCOPE OF THE ITALIAN ANTI-HYBRID RULES TO HYBRID MISMATCHES THAT ARISE 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.
3.2 ITALIAN ANTI-HYBRID RULES

In line with ATAD II, articles 8(1) and 8(2) of ATAD Implementing Decree provides for two general rules to counteract double deduction outcome and deduction non-inclusion outcome respectively.

According to article 8(1) of ATAD Implementing Decree, if a hybrid mismatch results in a double deduction, as a primary rule, the deduction shall be denied in Italy if it is the investor jurisdiction. As a defensive rule, where the deduction is not denied in the investor jurisdiction, the deduction shall be denied in Italy if it is the payer jurisdiction.

According to article 8(2) of ATAD Implementing Decree, if a hybrid mismatch results in a deduction without inclusion, as a primary rule, the deduction shall be denied in Italy if it is the payer jurisdiction. As a defensive rule, where the deduction is not denied in the payer jurisdiction, the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) shall be included in income in Italy if it is the investor jurisdiction.

In addition, ATAD Implementing Decree provides for specific anti-hybrid rules to counteract imported hybrid mismatches, reverse hybrid mismatches and dual residency mismatches.

3.3 EXCLUSIONS FROM ITALIAN ANTI-HYBRID RULES

ATAD Implementing Decree provides for the following specific exclusions.

According to article 6(2)(d), differences in taxable income that are attributable to differences in the value ascribed to a payment, including through the application of transfer pricing, do not fall within the scope of a hybrid mismatch.

In addition, according to article 6(2)(e), benefits from the Italian notional interest deduction (so called ACE) do not give rise to hybrid mismatches.

The explanatory report of ATAD Implementing Decree specifies that also benefits from the notional interest deduction implemented by foreign jurisdictions do not lead to hybrid mismatches.

3.4 ROLE OF ITALY IN APPLYING ITALIAN ANTI-HYBRID RULES

In order to neutralise the effects of hybrid mismatches, anti-hybrid rules require a response from either the payer jurisdiction or the payee jurisdiction or the investor jurisdiction, as the case may be.

According to article 7 of ATAD Implementing Decree, Italy qualifies:

• as the payer jurisdiction, if the payment is deductible in the hands of an Italian Taxpayer;
• as the investor jurisdiction, if the payment made by a non-resident (or by a foreign permanent establishment of an Italian Taxpayer) is attributed to an Italian Taxpayer and it is deductible in its hands;
• as the payee jurisdiction, if the payer jurisdiction qualifies an Italian Taxpayer as payee.

3.5 HYBRID MISMATCHES COVERED BY ITALIAN ANTI-HYBRID RULES

As indicated above, ATAD Implementing Decree addresses several categories of hybrid mismatches, which will be analysed on the next page.

HYBRID FINANCIAL INSTRUMENT

According to article 6(1)(r)(1) of ATAD implementing Decree, a hybrid mismatch arrangement occurs in relation to a payment under a financial instrument or a hybrid transfer if the following conditions are met:

• such payment gives rise to a deduction without inclusion outcome;
• such payment is not included by the jurisdiction of the payee in a tax period that commences within twelve months of the end of the payer’s tax period in which the payment was deducted (Twelve-Month Period);

• the mismatch outcome is attributable to the different characterisation of the financial instrument (or the payment made under it) in the payer and in the payee jurisdictions.

RULES

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 8(2) of the ATAD I implementing Decree:

• if Italy is the payer jurisdiction, it denies the deduction in the payer jurisdiction or the mismatch is neutralized in another Country. In order to avoid double taxation, if Italy denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee after the Twelve-Month Period, Italy will allow the deduction (previously denied) in the hands of the payer;
• if Italy is the payee jurisdiction, it includes the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country.

It has to be pointed out that a hybrid financial instrument could potentially falls in the scope of both ATAD II and the Parent-Subsidiary Directive. In such a case, according to recital no. 30 of ATAD II, the Parent-Subsidiary will prevail leading to an opposite result. Indeed, while the primary rule under ATAD II provides for a denial of the deduction in the payer jurisdiction, article 4(1)(a) of the Parent-Subsidiary Directive provides for a taxation in the hands of the payee parent company to the extent that the profits are deductible by the subsidiary.

EXCEPTIONS

A payment under a financial instrument or a hybrid transfer does not give rise to a hybrid mismatch where the non-inclusion in the payee jurisdiction is solely due to (i) the tax status of the payee or (ii) the fact that the instrument is held subject to the terms of a special tax regime.

In order to interpret the two exceptions indicated above, reference can be made to BEPS Action 2 Report, which is explicitly mentioned both by recital 28 of ATAD II and by the explanatory report of ATAD Implementing Decree.

As explained by BEPS Action 2 Report, paragraph 96, the hybrid financial instrument rule does not apply to mismatches that are solely attributable to the tax status of the taxpayer. Where, however, the mismatch can also be attributed to the tax treatment of the instrument (i.e. the mismatch would have arisen even in respect of payment between taxpayers of ordinary status) the hybrid financial instrument rule will continue to apply. Example 1.5 of BEPS Action 2 Report illustrates the application of this principle:

46 Article 27-bis of Presidential Decree 29 September 1973 no. 600 implemented in Italy the Parent-Subsidiary Directive.
“a deductible interest payment is made to a sovereign wealth fund that is a tax-exempt entity under the laws of its own jurisdiction. The rule will not apply if the tax-exempt status of the fund is the only reason for the D/NI outcome. If the hybrid financial instrument rule does not apply to mismatches that are solely attributable to the special tax regime under which an instrument is held. The application of this principle is illustrated by Example 1.8 of BEPS Action 2 Report, where the payee holds the financial instrument through a foreign branch: “The fact that the loan is held through a foreign branch is not a term of the instrument or part of the relationship between the parties. Therefore, if the mismatch arises solely due to the operation of the branch exemption in the residence country then the mismatch will not be a hybrid mismatch”.

**EXAMPLE**

Here below an example of a hybrid mismatch deriving from a hybrid financial instrument which is line with Example 1.1 of BEPS Action 2 Report and it is also mentioned by the explanatory report of ATAD Implementing Decree.

A Co (a company resident in Country A) owns all the shares in B Co (a company resident in Country B). A Co lends money to B Co. The loan is treated as a debt instrument under the laws of Country B but as an equity instrument (i.e. a share) under the laws of Country A. Interest payments on the loan are treated as a deductible expense under Country B law but as exempt dividends under Country A law.

The interest payment described in the example falls within the scope of the hybrid financial instrument rule.

If Italy is Country B, it denies B Co the deduction for the interest paid to A Co, unless the mismatch is neutralized in another Country. In order to avoid double taxation, if Italy denies B Co the deduction and Country A includes the payment in the ordinary income of A Co after the Twelve-Month Period, Italy will allow B Co the deduction (previously denied).

If Italy is Country A, it includes the payment in the ordinary income of A Co, unless the deduction is denied in Country B48 or the mismatch is neutralized in another Country.

**PAYMENT TO A HYBRID ENTITY**

The ATAD Implementing Decree defines “hybrid entity” as any entity or arrangement that for income tax purposes is regarded as an opaque entity (i.e. a taxable entity) under the laws of one jurisdiction and as a transparent entity (i.e. an entity whose income or expenditure is treated as income or expenditure of one or more other persons) under the laws of another jurisdiction.

According to article 6(1)(r)(3) of ATAD Implementing Decree, a hybrid mismatch arrangement occurs in relation to a payment to a hybrid entity if the following conditions are met:

• such payment gives rise to a deduction without inclusion outcome;

• the 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 and the jurisdiction of any person with a participation in that hybrid entity.

**RULES**

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 8(2) of the ATAD Implementing Decree:

• if Italy is the payer jurisdiction, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country. In order to avoid double taxation, if Italy denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee after the Twelve-Month Period, Italy will allow the deduction (previously denied) in the hands of the payer.

• if Italy is the payee jurisdiction, it includes the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction49 or the mismatch is neutralized in another country. The scenario where Italy is the Country of establishment of the reverse hybrid entity is analysed in paragraph 3.5 “Reverse hybrid mismatches”

**EXAMPLE**

Here below an example of a hybrid mismatch deriving from a payment to a hybrid entity.

A Co establishes B Co as the holding company for its operating subsidiary C Co. B Co is a reverse hybrid entity (i.e. an entity that is treated as transparent for tax purposes in Country B but as a taxable entity under Country A law). B Co lends money to C Co.

Interest payments on the loan are treated as a deductible expense under Country C law but non included in income by either B Co (because Country B treats it as transparent for tax purposes) and A Co (because Country A treats B Co as a taxable entity).

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48 The denial of the deduction in Country B shall result either from a declaration of B Co or from certain and precise elements.

49 The denial of the deduction in the payer jurisdiction shall result either from a declaration of the payer or from certain and precise elements.
If Italy is Country A, it includes the payment in the ordinary income of A Co, unless the deduction is denied in Country C54 or the mismatch is neutralized in another Country55.

The scenario where Italy is Country B is analyzed in paragraph 3.5 “Reverse hybrid mismatches”.

**PAYMENT TO AN ENTITY WITH ONE OR MORE PERMANENT ESTABLISHMENTS**

According to article 6(1)(r)(4) of ATAD Implementing Decree, a hybrid mismatch arrangement occurs in relation to a payment to an entity with one or more permanent establishments if the following conditions are met:

- such payment gives rise to a deduction without inclusion outcome (i.e. in the payer jurisdiction the payment is deducted; in the head office jurisdiction the payment is not included since it is allocated to the foreign permanent establishment to which a domestic branch exemption regime applies and in the permanent establishment jurisdiction the payment is not included since it is allocated to the head office);

- the mismatch outcome is the result of differences in the allocation of the payment 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.

**RULES**

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 8(2) of the ATAD Implementing Decree:

- if Italy is the payer jurisdiction, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country55. In order to avoid double taxation, if Italy denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee after the Twelve-Month Period, Italy will allow the deduction (previously denied) in the hands of the payer;

- if Italy is the head office jurisdiction, it includes the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the head office, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country55;

- if Italy is the permanent establishment jurisdiction, it includes the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the permanent establishment, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country.

**EXCEPTIONS**

A payment to an entity with one or more permanent establishments does not give rise to a hybrid mismatch where the non-inclusion in the payee jurisdiction would have in any case occurred due to the tax-exempt status of the payee under the laws of its jurisdiction.

**EXAMPLE**

Here below an example of a hybrid mismatch deriving from a payment to an entity with a permanent establishment illustrated under paragraph 8 of the 2017 OECD BEPS report on Action 2 regarding branch mismatches.

A Co establishes a permanent establishment in Country B (B Branch) and a subsidiary in Country C (C Co).

B Branch lends money to C Co. Interest payments on the loan are treated as a deductible expense under Country C law.

Under the law of Country B, interest payments on the loan are allocated to A Co and therefore they are not included in the ordinary income of B Branch. In addition, under the law of Country A, interest payments on the loan are allocated to B Branch to which a domestic branch exemption regime applies, therefore they are not included in the ordinary income of A Co.

The interest payment described in the example falls within the scope of the anti-hybrid rule regarding payment to an entity with a permanent establishment.

If Italy is Country C, it denies C Co the deduction for the interest paid, unless the mismatch is neutralized in another Country54.

If Italy is Country A, it includes the payment in the ordinary income of A Co, unless the deduction is denied in Country C55 or the mismatch is neutralized in another Country56.

If Italy is Country B, it includes the payment in the ordinary income of B Branch, unless the deduction is denied in Country C or the mismatch is neutralized in another Country.

**PAYMENT TO A DISREGARDED PERMANENT ESTABLISHMENT**

Article 6(1)(p) of ATAD Implementing Decree defines “disregarded permanent establishment” as the exercise of an activity 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.

According to article 6(1)(r)(5) of ATAD Implementing Decree, a hybrid mismatch arrangement occurs in relation to a payment to a disregarded permanent establishment if it gives rise to a deduction without inclusion outcome (i.e. in the payer jurisdiction the payment is deducted; in the head office jurisdiction the payment is not included since it is allocated to the foreign permanent establishment to which a domestic branch exemption regime applies and in the permanent establishment jurisdiction the payment is not included since there is no permanent establishment under the law of its jurisdiction).

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54 The inclusion in Country A or in Country B shall result either (i) from a declaration of A Co or B PE or (ii) from certain and precise elements.
55 The denial of the deduction in Country C shall result either from a declaration of C Co or from certain and precise elements.
56 The non-inclusion in the head office jurisdiction could also arise from the application of the tax treaty between the head office jurisdiction and the permanent establishment jurisdiction, if the double taxation is eliminated through the exemption of the profits of the permanent establishment.
57 The inclusion in the Country of the head office or in the Country of the permanent establishment shall result either (i) from a declaration of the head office or the permanent establishment or (ii) from certain and precise elements.
58 The denial of the deduction in the payer jurisdiction or the inclusion in the Country of the permanent establishment shall result either (i) from a declaration of the payer or the permanent establishment or (ii) from certain and precise elements.
59 Article 32 of the Regulation 28 August 201, issued by the Italian tax authorities in relation to the Italian branch exemption regime, provides for a similar rule: “If double deduction or double exemption outcomes arise from mismatches between Italian law and the law of the Country where the exempted branch is established, the related effects will be neutralized in order to avoid an erosion of the Italian taxable base”.
60 Article 3(3) of the Regulation 28 August 2017, issued by the Italian tax authorities in relation to the Italian branch exemption regime, provides that the branch exemption regime applies only if a permanent establishment is recognized in the foreign country.
The inclusion in the Country of the head office or in the Country of the permanent establishment shall result either (i) from a declaration of the head office or the permanent establishment or (ii) from certain and precise elements.

In order to avoid double taxation, the ATAD Implementing Decree, it denies the deduction of the article 8(2)(a) of the ATAD Implementing Decree. According to recital 29 of ATAD II, this rule has a priority over the general anti-hybrid rules provided by article 9(1) and 9(2), which correspond to article 8(2)(a) and 8(2)(b) of the ATAD Implementing Decree.

If Italy is the payer jurisdiction, it denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee after the Twelve-Month Period, Italy will allow the deduction (previously denied) in the hands of the payer.

A payment to an entity with one or more permanent establishments does not give rise to a hybrid mismatch where the non-inclusion in the payee jurisdiction would have in any case occurred due to the tax-exempt status of the payee under the laws of its jurisdiction.

According to articles 6(1)(c)(6) and 6(2)(b) of the ATAD Implementing Decree, a hybrid mismatch arrangement occurs in relation to a disregarded payment made by a hybrid entity if the following conditions are met:

- such payment gives rise to a deduction without inclusion outcome (i.e. in the payer jurisdiction the payment is deducted since the payer is considered as an opaque entity and the payments between the payer-subsidiary and the payee-parent are disregarded);
- the mismatch outcome is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction;
- the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income. Article 6(1)(g) of the ATAD Implementing Decree defines “dual-inclusion income” as any item of income that is included under the laws of both jurisdictions where the mismatch outcome has arisen.

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 8(2) of the ATAD Implementing Decree:

- if Italy is the payer jurisdiction, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country;
- if Italy is the payee jurisdiction, it includes the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country.

A disregarded payment made by a hybrid entity does not give rise to a hybrid mismatch where the non-inclusion in the payee jurisdiction would have in any case occurred due to the tax-exempt status of the payee under the laws of its jurisdiction.

Here below an example of a hybrid mismatch deriving from a disregarded payment made by a hybrid entity, which is mentioned by the explanatory report of ATAD Implementing Decree.

B Co is a hybrid entity that is fully owned by A Co (a company resident in Country A). B Co is treated as a separate taxable entity under Country B law. It has no income and it is consolidated with B Sub 1, under Country B’s tax grouping regime.

A Co lends money to B Co. Country A considers B Co as a transparent entity and does not recognise the payments from B Co to A Co.

The interest payment described in the example falls within the scope of the anti-hybrid rule regarding payment to a disregarded permanent establishment.

If Italy is Country A, it includes the payment in the ordinary income of A Co, unless the tax treaty between Italy and another Country imposes the exemption of the profits of the permanent establishment.

If Italy is Country C, it denies C Co the deduction for the interest paid, unless the mismatch is neutralized in another Country.

The interest payments on the loan are treated as a deductible expense under Country C law. Under the law of Country A, interest payments on the loan are allocated to B Branch to which a domestic branch exemption regime applies, therefore they are not included in the ordinary income of A Co. Under the law of Country B, it is not recognised the existence of a permanent establishment and therefore interest payments on the loan are not taxed in Country B.

The ATAD DIRECTIVES

According to the ATAD Implementing Decree:

- if Italy is the head office jurisdiction, according to article 8(4) of the ATAD Implementing Decree, it includes the payment in the ordinary income of the head office, unless the tax treaty between Italy and another Country imposes the exemption of the profits of the permanent establishment. According to recital 29 of ATAD II, this rule has a priority over the general anti-hybrid rules provided by article 9(1) and 9(2), which correspond to article 8(2)(a) and 8(2)(b) of the ATAD Implementing Decree.
- if Italy is the payer jurisdiction, according to article 8(2)(a) of the ATAD Implementing Decree, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country. In order to avoid double taxation, it denies the deduction of the article 8(2)(a) of the ATAD Implementing Decree, it denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee after the Twelve-Month Period, Italy will allow the deduction (previously denied) in the hands of the payer.

A payment to an entity with one or more permanent establishments does not give rise to a hybrid mismatch where the non-inclusion in the payee jurisdiction would have in any case occurred due to the tax-exempt status of the payee under the laws of its jurisdiction.

Here below an example of a hybrid mismatch deriving from a disregarded payment made by a hybrid entity, which is mentioned by the explanatory report of ATAD Implementing Decree.

B Co is a hybrid entity that is fully owned by A Co (a company resident in Country A). B Co is treated as a separate taxable entity under Country B law. It has no income and it is consolidated with B Sub 1, under Country B’s tax grouping regime.

A Co lends money to B Co. Country A considers B Co as a transparent entity and does not recognise the payments from B Co to A Co.

The interest payment described in the example falls within the scope of the anti-hybrid rule regarding payment to a disregarded permanent establishment.

If Italy is Country A, it includes the payment in the ordinary income of A Co, unless the tax treaty between Italy and another Country imposes the exemption of the profits of the permanent establishment.

If Italy is Country C, it denies C Co the deduction for the interest paid, unless the mismatch is neutralized in another Country. In order to avoid double taxation, it denies the deduction of the article 8(2)(a) of the ATAD Implementing Decree, it denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee after the Twelve-Month Period, Italy will allow the deduction (previously denied) in the hands of the payer.

The ATAD DIRECTIVES

According to the ATAD Implementing Decree:

- if Italy is the head office jurisdiction, according to article 8(4) of the ATAD Implementing Decree, it includes the payment in the ordinary income of the head office, unless the tax treaty between Italy and another Country imposes the exemption of the profits of the permanent establishment. According to recital 29 of ATAD II, this rule has a priority over the general anti-hybrid rules provided by article 9(1) and 9(2), which correspond to article 8(2)(a) and 8(2)(b) of the ATAD Implementing Decree.
- if Italy is the payer jurisdiction, according to article 8(2)(a) of the ATAD Implementing Decree, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country. In order to avoid double taxation, it denies the deduction of the article 8(2)(a) of the ATAD Implementing Decree, it denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee after the Twelve-Month Period, Italy will allow the deduction (previously denied) in the hands of the payer.

A payment to an entity with one or more permanent establishments does not give rise to a hybrid mismatch where the non-inclusion in the payee jurisdiction would have in any case occurred due to the tax-exempt status of the payee under the laws of its jurisdiction.

Here below an example of a hybrid mismatch deriving from a disregarded payment made by a hybrid entity, which is mentioned by the explanatory report of ATAD Implementing Decree.

B Co is a hybrid entity that is fully owned by A Co (a company resident in Country A). B Co is treated as a separate taxable entity under Country B law. It has no income and it is consolidated with B Sub 1, under Country B’s tax grouping regime.

A Co lends money to B Co. Country A considers B Co as a transparent entity and does not recognise the payments from B Co to A Co.

The interest payment described in the example falls within the scope of the anti-hybrid rule regarding payment to a disregarded permanent establishment.

If Italy is Country A, it includes the payment in the ordinary income of A Co, unless the tax treaty between Italy and another Country imposes the exemption of the profits of the permanent establishment.

If Italy is Country C, it denies C Co the deduction for the interest paid, unless the mismatch is neutralized in another Country. In order to avoid double taxation, it denies the deduction of the article 8(2)(a) of the ATAD Implementing Decree, it denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee after the Twelve-Month Period, Italy will allow the deduction (previously denied) in the hands of the payer.

The ATAD DIRECTIVES

According to the ATAD Implementing Decree:

- if Italy is the head office jurisdiction, according to article 8(4) of the ATAD Implementing Decree, it includes the payment in the ordinary income of the head office, unless the tax treaty between Italy and another Country imposes the exemption of the profits of the permanent establishment. According to recital 29 of ATAD II, this rule has a priority over the general anti-hybrid rules provided by article 9(1) and 9(2), which correspond to article 8(2)(a) and 8(2)(b) of the ATAD Implementing Decree.
- if Italy is the payer jurisdiction, according to article 8(2)(a) of the ATAD Implementing Decree, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country. In order to avoid double taxation, it denies the deduction of the article 8(2)(a) of the ATAD Implementing Decree, it denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee after the Twelve-Month Period, Italy will allow the deduction (previously denied) in the hands of the payer.

A payment to an entity with one or more permanent establishments does not give rise to a hybrid mismatch where the non-inclusion in the payee jurisdiction would have in any case occurred due to the tax-exempt status of the payee under the laws of its jurisdiction.

Here below an example of a hybrid mismatch deriving from a disregarded payment made by a hybrid entity, which is mentioned by the explanatory report of ATAD Implementing Decree.

B Co is a hybrid entity that is fully owned by A Co (a company resident in Country A). B Co is treated as a separate taxable entity under Country B law. It has no income and it is consolidated with B Sub 1, under Country B’s tax grouping regime.

A Co lends money to B Co. Country A considers B Co as a transparent entity and does not recognise the payments from B Co to A Co.

The interest payment described in the example falls within the scope of the anti-hybrid rule regarding payment to a disregarded permanent establishment.

If Italy is Country A, it includes the payment in the ordinary income of A Co, unless the tax treaty between Italy and another Country imposes the exemption of the profits of the permanent establishment.

If Italy is Country C, it denies C Co the deduction for the interest paid, unless the mismatch is neutralized in another Country. In order to avoid double taxation, it denies the deduction of the article 8(2)(a) of the ATAD Implementing Decree, it denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee after the Twelve-Month Period, Italy will allow the deduction (previously denied) in the hands of the payer.
The interest payment described in the example falls within the scope of the rule related to disregarded payments made by a hybrid entity.

If Italy is Country B, it denies B Co the deduction for the interest paid to A Co, unless the mismatch is neutralized in another Country.

If Italy is Country A, it includes the payment in the ordinary income of A Co, unless the deduction is denied in Country B or the mismatch is neutralized in another Country.

PAYMENT BETWEEN THE HEAD OFFICE AND PERMANENT ESTABLISHMENT OR BETWEEN TWO OR MORE PERMANENT ESTABLISHMENTS

According to articles 6(1)(r)(7) and 6(2)(b) of ATAD Implementing Decree, a hybrid mismatch arrangement occurs in relation to a payment between the head office and permanent establishment or between two or more permanent establishments if the following conditions are met:

• such payment gives rise to a deduction without inclusion outcome (i.e. in the payer jurisdiction the payment is deducted and in the payee jurisdiction the payment is not included since it is disregarded);

• the mismatch outcome is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction;

• the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income.

RULES

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 8(2) of the ATAD Implementing Decree:

• if Italy is the payer jurisdiction, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country. In order to avoid double taxation, if Italy denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee after the Twelve-Month Period, Italy will allow the deduction (previously denied) in the hands of the payer;

• if Italy is the head office jurisdiction, it includes the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the head office, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country.

EXAMPLE

Here below an example of a hybrid mismatch leading to a double deduction outcome.

A Co establishes B Co 1 as the holding company for its operating subsidiary (B Co 2). B Co 1 is a hybrid entity (i.e. an entity that is treated as a separate entity for tax purposes in Country B but as a disregarded entity under Country A law).

B Co 1 borrows money from a local bank. The interest on the loan is treated as a deemed royalty payment for the notional royalty payment.

If Italy is Country B, it denies B Branch the deduction for the notional royalty payment, unless the mismatch is neutralized in another Country.

If Italy is Country A, it includes the payment in the ordinary income of A Co, unless the deduction is denied in Country B or the mismatch is neutralized in another Country.

DOUBLE DEDUCTION OUTCOME

According to articles 6(1)(r)(8) and 6(2)(b) of ATAD Implementing Decree, a hybrid mismatch arises if the following conditions are met:

• a double deduction outcome occurs;

• the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income.

RULES

Since the hybrid mismatch gives rise to a double deduction outcome, according to article 8(1) of the ATAD Implementing Decree:

• if Italy is the investor jurisdiction, it denies the deduction of the payment in the hands of the investor;

• if Italy is the payer jurisdiction, it denies the deduction in the hands of the payer, unless the deduction is denied in the investor jurisdiction.

EXCEPTIONS

A payment between the head office and permanent establishment or between two or more permanent establishments does not give rise to a hybrid mismatch where the non-inclusion in the payee jurisdiction would have in any case occurred due to the tax-exempt status of the payee under the laws of its jurisdiction.

EXAMPLE

The illustration on the next page is an example of a hybrid mismatch arising from payments between the head office and permanent establishment, which is illustrated under paragraph 11 of the 2017 OECD BEPS report on Action 2 regarding branch mismatches.

A Co supplies services to an unrelated company (C Co) through a branch located in Country B. The services supplied by the branch exploit underlying intangibles owned by A Co.

Country B attributes the ownership of those intangibles to the head office and treats the branch as making a corresponding arm’s length payment to compensate A Co for the use of those intangibles. This deemed payment is deductible under Country B law but is not recognised under Country A law (because Country A attributes the ownership of the intangibles to the branch). Meanwhile, the services income received by B branch is exempt from taxation under Country A law due to a domestic branch exemption regime.

The deemed royalty payment described in the example falls within the scope of the anti-hybrid rule regarding payments between the head office and permanent establishment.

If Italy is Country B, it denies B Branch the deduction for the notional royalty payment, unless the mismatch is neutralized in another Country.

If Italy is Country A, it includes the payment in the ordinary income of A Co, unless the deduction is denied in Country B or the mismatch is neutralized in another Country.

The ATAD DIRECTIVES
The interest payment described in the example falls within the scope of the rule regarding double deduction mismatches:

- If Italy is Country A, it denies the deduction of the payment in the hands of A Co;
- If Italy is Country B, it denies the deduction in the hands of the B Co 1, unless the deduction is denied in Country A.

**IMPORTED HYBRID MISMATCHES**

Recital 25 of ATAD II states that “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”.

In order to counteract such imported mismatches, Italy introduced a specific rule in line with article 9(3) of ATAD II.

According to article 8(3) of ATAD Implementing Decree, an imported hybrid mismatch arises if a deductible payment in Italy funds an expenditure which is deducted in another jurisdiction and gives rise to a hybrid mismatch. In particular, an imported hybrid mismatch occurs if the following conditions are met:

- a deductible payment in Italy directly or indirectly funds a deductible expenditure giving rise to a hybrid mismatch;
- such hybrid mismatch is achieved through a transaction or series of transactions between associated enterprises or entered into as part of a structured arrangement.

Article 6(1)(q) of the ATAD Implementing Decree provides for a definition of “structured arrangement” in line with ATAD II: “an arrangement involving a hybrid mismatch where the economic impact of the mismatch has been evaluated in the negotiation of 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”.

**RULE**

In case of imported hybrid mismatches, Italy shall deny the deduction of the payment which fund expenditure involving a hybrid mismatch, unless one of the jurisdictions involved in the transaction or series of transactions has made an equivalent adjustment in respect of such hybrid mismatch.

**EXAMPLE**

On the next page is an example of an imported hybrid mismatch. In order to counteract such imported mismatches, Italy introduced a specific rule in line with article 9(3) of ATAD II.

The interest payment from C Co to B Co falls within the scope of the rule regarding double deduction mismatches because:

- the deductible interest payment in the hands of C Co directly funds a deductible expenditure (i.e. the interest payment deducted by B Co) giving rise to a hybrid mismatch;
- such hybrid mismatch is achieved through a series of transactions between associated enterprises.

If Italy is Country C, it denies the deduction of the interest payment in the hands of C Co, unless Country B or Country A have made an adjustment in respect of such hybrid mismatch.

**REVERSE HYBRID MISMATCHES**

A reverse hybrid entity is an entity or arrangement that for income tax purposes is regarded as an opaque entity (i.e. a taxable entity) under the laws of the investor jurisdiction and as a transparent entity (i.e. an entity whose income or expenditure is treated as income or expenditure of one or more other persons) under the laws of its establishment.

In line with article 9a of ATAD II, article 9 of ATAD Implementing Decree provides for a specific anti-hybrid rule neutralizing reverse hybrid mismatches. According to this provision, if certain conditions are met, the reverse hybrid entity established in Italy shall not be considered as transparent but as a taxable entity in relation to the income not taxed in another jurisdiction.

According to recital 29 of ATAD II, this rule has a priority over the general anti-hybrid rules provided by articles 9(1) and 9(2) of ATAD II which are aimed to counteract double deduction and deduction non-inclusion outcomes respectively (see paragraph 3.2). In addition, it has to be noted that this specific anti-hybrid rule will apply from 1 January 2022.

According to article 9 of ATAD Implementing Decree, a reverse hybrid mismatch occurs if the following conditions are met:

- one or more associated non-resident entities hold in aggregate a direct or indirect interest in 50 per cent 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 Italy;
- the investor jurisdiction treats the hybrid entity as an opaque taxable entity;
- Italy treats the hybrid entity as transparent and does not tax its income.

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70 The denial of the deduction in Country A shall result either (i) from a declaration of A Co or (ii) from certain and precise elements.

71 Articles 9(1) and 9(2) of ATAD II correspond to articles 8(2)(a) and 8(2)(b) of the ATAD Implementing Decree.
The interest payment described in the example does not fall within the scope of the reverse hybrid mismatch rule because under the current Italian income tax system, interest payments received by B Co are taxed in Italy in the hands of A Co.

DUAL RESIDENCY MISMATCHES

The dual residency mismatches rule covers cases where an Italian Taxpayer is resident in Italy and also in another jurisdiction. A double deduction outcome could arise in this case.

In line with article 9b of ATAD II, the ATAD Implementing Decree provides for a specific anti-hybrid rule neutralizing dual residency mismatches.

According to article 10 of ATAD Implementing Decree, a dual residency mismatch occurs if the following conditions are met:

- the Italian Taxpayer is resident in Italy and also: (i) in another non-EU jurisdiction or (ii) in another Member State but it is deemed to be a resident of the other Member State according to the double taxation treaty between Italy and the other Member State;
- a double deduction outcome occurs (i.e. a payment is deductible under the laws of both Italy and the other jurisdictions).

RULE

If a dual residency mismatch occurs, Italy 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;
- the mismatch is not neutralized in another Country.

If Italy denies the deduction in the hands of an Italian Taxpayer under the dual residency mismatch rule and it derives a dual inclusion income in a subsequent fiscal year, such income will be exempt for income tax purposes up to the amount of the denied deduction.

EXAMPLE

Here is an example of a dual residency mismatch.

A Co owns all of the shares in AB Co which is resident for tax purposes in both Country A and Country B. A Co is consolidated with AB Co under Country A law.

AB Co owns all the shares in B Co, resident in Country B. AB Co is consolidated with B Co under Country B law. AB Co does not have any taxable income.

Interest payment from AB Co to the Bank are deducted both in Country A against the taxable income of A Co and in Country B against the taxable income of B Co. In both cases the deduction is not set off against dual inclusion income.

The interest payment from AB Co to the Bank falls within the scope of the rule regarding dual residency mismatches.

If Italy is Country A and Country B is not an EU Member State, Italy shall deny the deduction to the extent that Country B allows the duplicate deduction.

If Italy is Country A and Country B is an EU Member State, if AB Co is deemed to be a resident of Country B according to the double taxation treaty between Italy and Country B, Italy shall deny the deduction to the extent that Country B allows the duplicate deduction.

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72 Article 23(1)(g) of the Italian Income Tax Code.
3.6 IMPACT OF ITALIAN ANTI-HYBRID RULES ON INVESTMENT FUNDS

Investment funds could be impacted by anti-hybrid rules. In particular, they can qualify as reverse hybrid entities since in certain jurisdiction they are treated as fiscally transparent in order to provide for neutrality between direct investments and investments through a fund.

Considering that Italy treats foreign entities with or without legal personality as taxable entities, if an Italian investor holds units in an investment fund which is fiscally transparent under the law of its establishment, hybrid rules described in paragraph 3.5 “Payment to a hybrid entity” could apply.

3.7 CONCLUSIONS

Articles from 6 to 11 of ATAD Implementing Decree introduced in Italy hybrid mismatch rules in line with ATAD and the conclusions of Action 2 of the OECD/G20 BEPS project. Such provisions will apply from January 1, 2020 except for the reverse hybrid mismatches rule which will be applicable from 1 January 2022.

The scope of the Italian Anti-Hybrid Rules is broader than the one of the ATAD, the latter being applicable only to taxpayers that are subject to corporate income tax in a Member State. Indeed, Italian Anti-Hybrid Rules cover all taxpayers subject to income tax in Italy on their business income, including individuals.

In addition, the explanatory report of ATAD Implementing Decree clarifies that the hybrid mismatches targeted by the Italian Anti-Hybrid Rules are only those that give rise effectively and not just potentially to a deduction / non-inclusion or double deduction or indirect deduction / non-inclusion outcome.

As indicated in the explanatory report of ATAD Implementing Decree, under the current Italian income tax system, the reverse hybrid mismatch rule should not apply in Italy. Indeed, income related to transparent entities established in Italy is attributed to the non-resident investors and taxed in Italy in their hands.

Investment funds could be impacted by anti-hybrid rules. Considering that Italy qualifies foreign entities with or without legal personality as taxable entities, if an Italian investor holds units in an investment fund which is fiscally transparent under the law of its establishment, hybrid rules described under paragraph 3.5 “Payment to a hybrid entity” could apply.

4 SPANISH IMPLEMENTATION OF THE INTEREST LIMITATION RULE

4.1 INTRODUCTION

Spain has been introducing since 2012 several rules covering many of the aspects regulated under ATAD rules. In this regard, and as response to the financial crisis and following the precedents in Europe (and, mainly, the German one), Spain firstly adopted in march 2012 an “interest-barrier” rule together with some other anti-abuse provisions in order to prevent restructuring processes aimed at generating artificial intra-group leveraging in Spain through the acquisition to another group companies by Spanish entities of participations in subsidiaries which income (dividends) would be, on the other hand, tax exempt.

Even though the first regulation of the “interest-barrier” rule was also aimed at having an “anti-abuse” purpose and, therefore, several “escape clauses” were introduced (similarly to the German precedent), those “escape clauses” were eliminated only three months after the rule was put in place, defining a financial expenses limitation that was quite broad once the minimum 1-million threshold was exceeded (with the only exception of several financial entities).

The Spanish Corporate Income Tax Law was extensively amended in 2015 and, in that moment, the “interest-barrier” rule was slightly modified

The Spanish former Government already prepared a Draft Law for the implementation of several ATAD rules. This was published for public information in October 2018. Since that moment, the Parliament has been dissolved and a new Government appointed.

Considering that the President appointed is the same and its party rules majority in the new Government, we expect that the same or very similar rules will be recovered for the new draft Law.

Spain considered in that draft Law that the interest barrier limitation described above is similar to the one provided in ATAD and, therefore, communicated to the EU Commission this aspect, receiving a favourable response and, therefore, extending to 2024 the effective implementation in Spain of the ATAD rules, which differ in certain aspects with the Spanish internal provision.

Therefore, the comments in the sections below will mainly describe the original 2012 interest barrier rule together with the 2015 amendments.

4.2 GENERAL RULE

According to article 16 of the Spanish Corporate Income Tax Law, net financial expenses (for simplicity “net interest expenses”) are deductible in the tax period in which they are incurred up to 30% of the “Operating Profit”.

The net interest expense is defined as the excess of net financial expense over the financial income, being financial income and expenses understood (according to the Tax Administration interpretation) as those deriving from the enterprise financing or leveraging.

On the other hand, the Operating Profit is a sort of EBITDA determined upon the accounting exploitation income but eliminating the effect of depreciation, impairments, subsidies, income derived from the transfer of fixed assets and adding the income from dividends derived from certain qualifying participations.

Net financial expenses would be tax deductible up to €1 million even if they exceed the abovementioned ratio.
The unused net financial expense may be deducted in the following tax periods together with the net expenses of the period and subject to the same limitation. Although the initial interest-barrier rule limited to 18 the future tax periods in which the unused expenses may be applied, the 2015 reform eliminated this limitation and, therefore, at the present time, there is no temporal limitation for its application in the future, the same as happens with pending tax losses.

In case that the net financial expenses do not reach the 30% limit, the difference would be added to the limit within the following 5 years, until the difference is offset.

If the tax period duration is less than a natural year, the €1 million “safe harbour” shall be reduced proportionally.

For periods commencing in 2015 onwards, a new specific limitation was put into place regarding leveraged transactions (the “anti-LBO rule”) that is analysed in a following section.

4.3 THE DEFINITION OF INTEREST EXPENSES AND REVENUES

The Spanish regulation used a controversial definition in this respect that lead to several doubts. The reason is that, from a literal point of view, the legal reference to financial income and expenses is not symmetrical. In this regard, the Law referred to “financial expenses” and to “income derived from the cession of own capital to third parties”, being the latter the one arising the questions, as it is linked with a definition which is not accounting nor financial but related to the regulation under Personal Income Tax.

Notwithstanding this, and aimed at providing a clear guidance, the Spanish General Directorate of Taxes issued a complete resolution in 16 July 2012 in which many of the questions arising from the new regulation were addressed, this being one of them. In this interesting resolution, the DGT stated that, although their naming could lead to confusion, both elements (expense and income) are aimed to be symmetrical. In addition, the DGT stated which expenses and income should be considered as “financial” for these purposes, by reference to certain accounts of the Profit and Loss account according to the Spanish General Accounting Chart.

In this regard, for example, the DGT resolution clarified that the falling under the limitation would be interest (explicit or implicit) expenses from bonds, debts, dividends from accounting debt instruments, interests from certain factoring transactions (without recourse), and the costs and commissions related with them.

The Spanish DGT also clarified that the reference to the “financial expenses” does not include those under that definition from an accounting perspective, but only those “derived from the leveraging” of the Company, excluding, this way, some expenses and losses, such as financial losses derived from securities, the financial actualization of provisions, or those financial expenses which are accounted as a higher asset value, for example.

4.4 THE DETERMINATION OF THE “OPERATIONAL PROFIT”

Regarding the concept of “Operating profit”, the Spanish Corporate Income Tax Law provides with a more extensive definition which is similar, but not identical, to the traditional concept of EBITDA and that also differs from the concept provided for in ATAD.

In this regard, the Spanish Law calculates the “Operating Profit” as the “exploitation result” (or “net operating income”, “resultado de explotación”) as defined in the Profit and Loss Account according to Spanish Accounting rules-, eliminating the depreciation, subsidies, impairments and income/losses derived from the transfer of fixed assets and adding the income (dividends) derived from participations in which a minimum 5% is held or the acquisition cost is at least €20 million, unless the those participations were acquired though leveraging which financial expenses are not deductible due to specific anti-abuse provisions.

As this definition is different from the EBITDA definition stated in ATAD, we believed that this shall be modified accordingly once ATAD is implemented in Spain.

4.5 THE ANTI-LBO RULE

For periods commencing in 2015 onwards, a new specific limitation was put into place regarding leveraged transactions (the “anti-LBO rule”).

According to this specific limitation (which is additional to the general one, that applies in any case), financial expenses derived from debts incurred for the acquisition of participations in other entities shall be deducted with the additional limit of 30% of the Operating profit of the entity making such acquisition, without taking into consideration the Operating profit corresponding to any entity that may merge with the acquirer within the following four years or that may be integrated into the same tax consolidation group within the same period.

This specific and addition anti-LBO limitation would not apply in the period in which the acquisition is made if the acquisition is leveraged in a maximum of 70% of the total acquisition price and, in the following eight periods, as long as the leveraging is reduced, at least, in the proportion needed to reach a maximum leverage of 30% at the end of said eight-year period.

4.7 SOCIMI COMPANIES

Spain implemented a specific tax regimen for REITS, the so-called, “SOCIMI” regime. This legal and tax regime was amended in 2011 and has been relatively successful since that moment.

It is worth mentioning that, even though companies subject to this particular legal and tax regime are not excluded from the interest barrier rule, the fact that they are subject to a special 0% tax rate determined that the limitation does not apply from a practical point of view.
**5 SPANISH IMPLEMENTATION OF THE ANTI-HYBRID RULES**

Spain has not already implemented ATAD rules regarding hybrid mismatched nor there is any draft Law that may anticipate the final wording of such implementation. Despite this, Spain has been recently, since 2013, introducing several specific rules to address particular situations regarding hybrid mismatches that will be analysed in the following subsections below:

- **Dividend payments**
- **Profit participating loans and equity/debt instruments**
- **Hybrid payments**
- **Securities lending**
- **Losses from Permanent Establishments**

**5.1 DIVIDEND PAYMENTS**

In 2015 Spain modified the participation exemption regime. Until that moment, foreign dividends may benefit from a full participation exemption while Spanish source dividends were subject to a dual regime:

- **Dividends from qualifying participations (i.e. participation of a minimum 5% held for at least one year) may benefit from a 100% tax credit (applicable against the tax quote);**
- **Dividends from non-qualifying participations would only benefit from a 50% tax credit.**

In addition, profits derived from the transfer of non-resident qualifying participations may also benefit from a full tax exemption regime while profits derived from the sale of Spanish subsidiaries would be taxable in any case on the amount of the realised capital gains of the transferred entity (and only the part of the gain corresponding to realised profits may benefit from a tax credit to avoid double taxation).

In 2015, a complete review and reform of the Spanish Corporate Income Tax was made, and the participation exemption regime for dividends and gains derived from the transfer of securities (article 21 of the Spanish CIT Law) was simplified and its scope was significantly broadened, including the dividends derived from qualifying Spanish subsidiaries. Equally, from 2015 onwards, the whole gain obtained on the transfer of Spanish qualifying subsidiaries may also benefit from this full participation exemption regime, including the part corresponding to unrealised gains. In all cases, certain requirements shall be met (mainly, a minimum 5% participation and 1-year minimum holding period, together with other requirements).

Under this tax reform this regard, certain limitations were also introduced to avoid hybrid mismatches. In this regard, article 21 of the Spanish CIT Law was modified and a new limitation was introduced so that the participation exemption would not be applicable to those dividends which distribution generated a tax deductible expense at the level of the subsidiary paying said dividend. This situation is only possible regarding dividends derived obtained abroad, as equity distributions are not tax deductible under Spanish CIT Law.

This limitation is aligned with the recommendation 2.1 in BEPS Action 2 and Directive 2014/86/EU and tries to address some real cases addressed at the Spanish Courts.
In any case, a conflict may arise between this provision and those set forth in the applicable Tax Treaty for the same situation, which shall prevail in case of conflict (although attention shall be given to the position under the Multilateral Agreement). In addition, we believe that this provision should not be applicable in any case regarding those dividends received from entities applying some kind of “notional interest” over equity.

5.2 PROFIT PARTICIPATING LOANS AND EQUITY/DEBT HYBRID INSTRUMENTS

Equally, in the 2015 CIT reform, several profit participating loans were assimilated to dividends for CIT purposes.

In this regard, the following modifications were introduced:

a) Expenses derived from profit participating loans granted by group entities (resident or not in Spain) would be considered as equity distributions and, therefore, would not be tax deductible in Spain (article 15 a) CIT Law).

b) Symmetrically, income derived from profit participating loans granted to group entities would be treated as dividends and, therefore, would be tax exempt under the participation exemption regime (not matter if the lender is a shareholder of the borrower or not) unless in the case that they generate a tax deductible expense at the level of the borrower (article 21.2.2 CIT Law).

In similar terms:

a) Expenses derived from equity instruments would not be tax deductible in any case, even if they are registered as debt-instruments for accounting purposes, such as non-voting shares or redeemable shares.

b) And, symmetrically, distributions from any equity instrument would be considered as a dividend, despite their accounting treatment.

5.3 HYBRID PAYMENTS

Article 15 j) of the CIT Law states one of the only specific rules regarding hybrid mismatches. According to this new provision, introduced for periods 2015-onwards, the expenses derived from transactions with related parties will not be tax deductible in Spain for the payer in case that, due to a different tax treatment or classification of the payment at the level of the recipient, they do not generate income, or generate a tax exempt income, or subject to a nominal tax rate lower than 10%.

5.4 SECURITIES LENDING

A specific rule was introduced in 2015 in order to address the tax treatment of securities lending transactions. In this regard, two separate provisions have been introduced to regulate the application of the international double tax credit or the participation exemption regime in these cases.

According to these provisions, the tax benefit (tax credit or participation exemption) would not be applicable to the recipient of the dividend when, according to a securities lending contract, the amount shall be paid to a third party and an expense be, therefore, registered. In these cases, it would be the beneficiary owner the one entitled to claim the tax credit or the exemption provided several requirements are met.

5.5 LOSSES FROM PERMANENT ESTABLISHMENTS

As a result of the financial crisis and the great drop of both accounting income and payment of Corporate Income Tax, the Spanish Parliament adopted since 2012 several rules for the purposes of broadening the taxable base and making it far more stable and less affected by fluctuant market situations.

In addition to the limitation for the deduction of interest payments, other limitations were introduced in 2013, such as limitations on the tax deduction of losses generated in certain intra-group transfers; the limitation on the tax deduction of losses derived from the transfer of participations that qualify for the participation exemption regime; the limitation of the tax deduction of impairments; and the limitation on the tax deduction of losses obtained abroad by permanent establishments.

As a general rule, positive income derived from permanents establishments abroad of Spanish entities is tax exempt in Spain. Under the original wording of the Law, negative income may be, on the contrary, included into the Spanish taxable base (and, therefore, be tax deductible). The amount of the loss deducted would then reduce the exemption of any eventual positive income obtained in the future (if any).

After the 2013 and 2015 reforms, losses derived from Permanents Establishments abroad are not tax deductible unless in the case of termination of the Permanent Establishment and only in the amount exceeding the positive income obtained in the past that benefited from the exemption regime.

Therefore, the Spanish Law adopts a symmetrical treatment both for income (exempt) and losses (non-deductible) derived from PEs abroad with the exception of the losses derived from the termination of the PE. Please note that, regarding subsidiaries, the Spanish Law does also allows the deduction of losses derived from the liquidation of the qualifying subsidiary reduced by the amount of exempt dividends obtained in the previous 10-years.

Even though this modification were not aimed at addressing hybrid mismatch it corresponds to the primary rule proposed by recommendation 6 for DD situations caused by payments from a hybrid payer.
6 LUXEMBOURG’S IMPLEMENTATION OF THE ATAD INTEREST LIMITATION RULE

6.1 INTRODUCTION

In Luxembourg, the EU Anti-Tax Avoidance Directive (ATAD) has been implemented by the law of 21 December 2018 (the “Law”), in the context of the 2019 Luxembourg tax reform. Amongst other anti-BEPS-related measures, the Law introduced the ATAD measure in relation to the limitation to the tax deductibility of interest payments. The limitation to the tax deductibility of interest expenses applies in Luxembourg since 1 January 2019.

6.2 GENERAL RULE

6.2.1 PRINCIPLE

The Law introduced a new article 168bis in the Luxembourg income tax law (LiTIL) which transposes into domestic law the interest deduction limitation rule for interest considered excessive, as provided for in article 4 of the Directive. Article 168bis of the LiTIL caps the deduction of loan interest and other financial costs incurred by a collective entity referred to in article 159 of the LiTIL or by a native permanent establishment of a collective entity referred to in article 160, paragraph 1 of the LiTIL. Following its adoption, and subject to certain conditions and limitations, “exceeding borrowing costs” shall be deductible only up to 30% of the corporate taxpayers’ earnings before interest, tax, depreciation and amortisation (EBITDA) or up to an amount of EUR 3 m (safe harbour), whichever is higher.

As a result, in the case of a collective entity which records exceeding borrowing costs in an amount of €8 million and an EBITDA of €20 million, the maximum authorized deduction is €6 million because the fraction of 30% of 20 million euros is worth €6 million. However, if this same taxpayer generated an EBITDA of €30 million, it could deduct the totality of its exceeding borrowing costs because the ratio of 30% of €30 million exceeds the amount of €8 million.

The so-called “safe harbour” provision ensures that taxpayers having limited exceeding borrowing costs are not targeted by the interest deduction limitation rule. The safe harbour rule reduces the administrative burden without significantly reducing the tax effect of the rule. Indeed, these taxpayers are less likely to contribute to base erosion and profit shifting. For example, when a collective entity records exceeding borrowing costs of €2.7 million and an EBITDA of €8 million, it will be able, thanks to monetary threshold of €3 million, to deduct the totality of the exceeding borrowing costs, notwithstanding the fraction of the EBITDA obtained.

In this context, the available threshold of deduction applies for any financial year, as defined in Article 17 of the LiTIL. Thus, in the event that a collective entity which regularly closes its financial year on March 31st modifies, during 2020, the closing date of future financial years to December 31st, the interest deduction limitation rule applies for the first time to the totality of the financial year going from 1 April 2019 to 31 March 2020 and a second time from 1 April 2020 to 31 December 2020.

The interest deduction limitation rule provides for a carry forward mechanism in regard to both non-deductible exceeding borrowing costs and unused interest deduction capacity:

- Non-deductible exceeding borrowing costs are exceeding borrowing costs which cannot be deducted in one tax period because they exceed the limit of 30% of the EBITDA and of €3 million. They can be carried forward in whole or in part without any time limitation.
- In addition, the borrowing costs of the corporate taxpayer that are lower than the 2 above limits qualify as qualify as “unused interest capacity”. This unused interest capacity can be carried forward over 5 tax years, only the taxpayer that borne the exceeding borrowing costs is allowed to benefit from carry forward mechanisms for the non-deductible exceeding borrowing costs and the unused interest capacity. In case of corporate reorganisations that fall within the scope of Article 170 (2) of the LiTIL (for example, mergers), exceeding borrowing costs and unused interest capacity will be continued at the level of the remaining entity.

6.3 THE DEFINITION OF INTEREST EXPENSES AND REVENUES

“Exceeding borrowing costs” subject to the interest limitation rule under Article 168bis of the LiTIL correspond to the amount by which the deductible “borrowing costs” of a taxpayer exceed the amount of taxable “interest revenues and other economically equivalent taxable revenues”.

Article 168bis of the LiTIL does not provide for a precise and rigorous definition of borrowing costs, but classifies them in three main categories to which the interest deduction limitation rule is generally intended to apply, namely:

1) the interest expenses on all forms of debt;
2) other costs economically equivalent to interest, and
3) expenses incurred in connection with the raising of finance.
The ATAD directive clearly indicates that the definition of these concepts will have to be given by reference to the Luxembourg law, which has some flexibility in respect to its implementation.

The limit on interest deductibility may, in particular, have a negative impact in case a Luxembourg company realizes income that cannot be classified as interest income. Examples include income from derivatives, trading income, dividends and capital gains on taxable assets.

6.4 THE DETERMINATION OF THE EBITDA
The acronym EBITDA stands for the taxpayer’s taxable earnings before interest, tax, depreciation and amortisation.

The EBITDA shall be calculated by adding back to the income subject to corporate tax in Luxembourg, the tax-adjusted amounts for exceeding borrowing costs as well as the tax-adjusted amounts for depreciation and amortisation calculated in accordance with articles 29 to 34 of the LITL. Tax exempt income shall be excluded from the EBITDA of a taxpayer.

As indicated, the EBITDA corresponds to the profit made before financial costs, taxes, depreciation and provisions, from which it obviously follows that, in order to determine the value of the EBITDA, said operating expenses, for as far as they are deducted, must be added to this profit. However, the increase of the income tax is not included in the EBITDA’s composition. In fact, with regard to direct income taxes, the corporate income tax, the net wealth tax and the municipal business tax, are not taken into account for the determination of the amount of the EBITDA for the simple reason that in respect of article 168 of the LITL, these expenses are non-deductible and thus are already included in the net income of the taxpayer. Therefore, they do not enter a second time in the calculation of the EBITDA. Foreign personal taxes referred to in article 13 of the LITL, if they exist, are not affected by the EBITDA’s definition and as such these taxes remain deductible from the tax base.

As for the composition of the EBITDA, the Law and the ATAD specify that exempt income should not be charged against the deductible borrowing costs. The reason is that, when determining the amount of deductible interests, only taxable income (i.e. non-exempt income) should be taken into consideration. Correlatively, exempt income, such as income from substantial participations in respect of article 166 of the LITL, are not taken into account and do not affect the EBITDA. Income exempt from corporate income tax, whether under a domestic provision or under a double tax treaty, should therefore not enter in the calculation of the EBITDA. As a corollary to this, the last sentence makes operating expenses which are related to exempt income non-deductible.

In the context of a tax consolidation, the ATAD provides the option for Member State to allow the application of the interest limitation rules either at an individual level or at a group level. Initially, the Luxembourg government considered that the effects of such option was not in line with the method of the determination of the total net income of the Luxembourg tax consolidation regime, which is obtained by considering as a basis the mass of the tax result of the integrated companies. It is the reason why this possibility was not initially retained in the Law. Nevertheless, following to a motion of the Luxembourg parliament, the optional provision under ATAD according to which EBITDA and exceeding borrowing costs can be determined either at the level of the tax consolidated group (in case several companies form a tax consolidated group) or at the level of each company of the tax consolidated group was introduced with retroactive effect as from 1 January 2019 (see point 6.6).

6.5 THE EXCLUSION OF PROJECT FINANCING
In accordance with the ATAD, Luxembourg excludes from the scope of the interest deduction limitation exceeding borrowing costs incurred on loans used to fund a long-term public infrastructure project where the project operator, borrowing costs, assets and income are all in the European Union. In such case, any income coming from such long-term public infrastructure project is excluded from interest deduction limitation. Article 168bis of the LITL defines the long-term public infrastructure project as a project considered in the general public interest, to provide, upgrade, operate and/or maintain a large-scale asset. In this respect, the Luxembourg law does not provide for more information than the ATAD.

6.6 DEDUCTIBILITY OF INTEREST EXPENSES IN CASE OF TAX CONSOLIDATION
In Luxembourg, the tax consolidation regime is laid down in article 164bis of the LITL.
After a motion submitted by the Luxembourg parliament requesting the Luxembourg government to introduce the option to apply the provisions relating to the limitation of the deductibility of interest rules at a tax consolidated group level and not only at the level of each company part of the tax consolidated group, Article 164bis of the LITL was redrafted by the law dated 26 April 2019. In order not to disadvantage tax consolidated groups, the Luxembourg legislator decided to give to companies wishing to become members of a tax consolidation group the choice to apply the method of calculation of the limitation of the deductibility of interest at the level of each member or at the group level.

Article 164bis of the LITL lays down the procedures for applying this limitation of the deductibility of interest in the context of the tax consolidation regime. This provision reproduces the rules of article 168bis of the LITL and adapts them to the specific needs of the tax consolidation.

GENERAL RULE: APPLICATION OF THE LIMITATION OF INTEREST DEDUCTIBILITY AT GROUP LEVEL

In principle, each tax consolidated entity is required to determine and declare the total of its net income without applying the provisions relating to the limitation of the deductibility of interest and to declare separately, the deductible borrowing costs in accordance with article 168bis of the LITL. The individual data of each member of the tax consolidated group, which contributes to the calculation of the limitation of the deductibility of interest, is then gathered at the level of the consolidating company.

Tax consolidated companies must therefore declare their borrowing costs. Only the borrowing costs incurred by members of the tax consolidated group during their membership of this group must be declared. When added together, the total borrowing costs of each entity correspond to the borrowing costs borne by the consolidating company for the calculation of the limitation of interest deductibility in the context of the tax consolidation. Consolidated companies must also declare taxable interest income and other economically equivalent taxable income within the meaning of article 168bis, paragraph 1, number 3 of the LITL. This taxable income made by each member of the tax consolidated group is then added up and the total corresponds to taxable interest income and other economically equivalent taxable income made by the consolidating company. The deduction of borrowing costs to the extent that the tax consolidated group's total borrowing costs exceed the group's total interest income. To this end, only tax-deductible borrowing costs are taken into account.

The general rule for limiting interest deductibility limits the deduction of the amount of interest incurred in respect of a taxation year to an amount equivalent to a fixed ratio of 30% of the EBITDA. The EBITDA of the consolidating company does not correspond to the sum of the individual EBITDA of all the members of the tax consolidated group. It corresponds to the algebraic sum of the total net income of all the members of the group, increased by the exceeding borrowing costs of the consolidating company, the amortizations and deductions for depreciation which were operated by each member of the group. Tax-exempt income earned by each member of the tax consolidated group (e.g. dividends under the parent company and subsidiary regime) are excluded. The same is true of operating expenses which are economically connected to the same exempt income.

The exceeding borrowing costs remain deductible up to a maximum amount of €3 million even when this amount exceeds the ratio of 30% calculated from the EBITDA of the consolidating company. The deduction limit applies each financial year. Exceeding borrowing costs which do not exceed the threshold of €3 million also remain deductible without limitation.

The limitation of interest deductibility therefore comes into effect when the amount of exceeding borrowing costs exceeds both the 30% ratio of the parent company's EBITDA and the threshold of €3 million.

The exceeding borrowing costs of the member of the consolidated Group, determined as under article 168bis of the ITA, which were not deductible before the admission of this member to the tax consolidated group in respect of a subsequent operating year cannot be deducted during the consolidation period. They can again be deducted by this taxpayer as from the first financial year during which he is returned to the individual tax system.

EXCEPTION: APPLICATION OF LIMITATION OF INTEREST DEDUCTIBILITY AT INDIVIDUAL LEVEL

The limitation of interest deductibility applies to each member of the tax consolidated group individually, in accordance with the provisions of article 168bis of the LITL, when all companies wishing to become members of the group choose, in the joint written request submitted to obtain the authorisation to be allowed to benefit from the tax consolidation regime, to apply the interest limitation rules at individual level.

Tax consolidated groups existing at the time of the entry into force of the rule on the limitation of interest deductibility at the individual level will depend on the business model of each group, but this choice must be well thought through in advance because of the consequences it may have on the group’s taxable base.

6.7 GRAND FATHERING CLAUSE

According to Article 168bis of the LITL, loans concluded before 17 June 2016 are excluded from the restrictions on interest deductibility. However, this grandfathering rule does not apply to any subsequent material modification of such loans.
The commentators of the Luxembourg draft law say: “In order to facilitate the transition to the new interest deduction limitation rule, the recital 8 of the directive states that “Member States could provide for a grandfathering clause that would cover existing loans to the extent that their terms are not subsequently modified, i.e. in case of a subsequent modification, the grandfathering would not apply to any increase in the amount or duration of the loan but would be limited to the original terms of the loan”. The intention of the Luxembourg legislator is therefore clear.

When the nominal amount of a loan granted before 17 June 2016 is increased after this date, the interest in relation to the increased amount would be subject to the interest limitation rules. Likewise, when the interest rate is increased after 17 June 2016, only the original interest rate would benefit from the grandfathering rule. Nevertheless, when companies are financed by a loan facility that determines a maximum loan amount and an interest rate, the entire loan amount should be excluded from the scope of the interest limitation rules irrespective of when the drawdowns have been made.

6.8 REAL ESTATE COMPANY

There is no specific Luxembourg provision in relation real estate companies.

6.9 BANKS AND INSURANCE COMPANIES - FINANCIAL UNDERTAKINGS AND STANDALONE ENTITIES

Article 168bis of the LITL explicitly excludes financial undertakings and standalone entities from its scope.

The aim pursued by the definition of financial companies is to cover all the entities regulated by a European directive or a European regulation. Financial undertakings are the ones regulated by the EU Directives and Regulations and include among others financial institutions, insurance and reinsurance companies, undertakings for collective investment in transferable securities (UCITS), alternative investment funds (AIF). Luxembourg opted to consider securitization entities within the meaning of Article 2 (2) of Regulation No (EU) 2017/2402 of European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation as “financial entities” within the meaning of ATAD and their exclusion from the scope of the interest limitation rule.

Other companies not regulated under a European directive or regulation are not covered by this definition, except, the AIF supervised under national law. For example, the AIF subject to the amended law of June 15, 2004 relating to the Venture Capital Investment Company (SICAR) which provides for the approval and supervision of the FIA by the Commission de Surveillance du Secteur Financier, is a targeted financial company.

Standalone entities are entities that (i) are not part of a consolidated group for financial accounting purposes and (ii) have no associated enterprise or permanent establishment. Thus, in order for a Luxembourg company to benefit from the standalone entity exception, it is necessary that none of the associated enterprises has directly or indirectly a participation of 25% or more. It is interesting to note that the definition of associated enterprise for the purpose of the newly introduced provisions is defined very broadly including individuals, companies and transparent entities such as partnerships.

7 LUXEMBOURG IMPLEMENTATION OF THE ATAD ANTI-HYBRID RULES

On 19 December 2019, the Luxembourg legislator passed the law implementing EU Directive 2017/952 of 29 May 2017 (the “Anti-Tax Avoidance Directive 2” or “ATAD 2”) which provides for a comprehensive framework to tackle hybrid mismatch arrangements in a EU context and in transactions involving third States. Most of the hybrid mismatch rules are included in a new version of Article 168ter of the LITL which entered into force on 1 January 2020. In addition, Article 168quater of the LITL provides for a reverse hybrid mismatch rule that will apply as of 1 January 2022.

7.1 SCOPE OF LUXEMBOURG ANTI-HYBRID RULES

7.1.1 SUBJECTIVE SCOPE

The hybrid mismatch rules apply to all Luxembourg corporate taxpayers, i.e. including entities within the meaning of Article 159 of the LITL (Luxembourg companies, cooperatives, etc.) and Luxembourg permanent establishments (PE) of non-resident corporate entities.

The scope of hybrid mismatch arrangements is generally limited to transactions between related parties. Therefore, the related party test is a cornerstone of the hybrid mismatch rules. A mismatch outcome shall not be treated as a hybrid mismatch within the meaning of Article 168ter of the LITL unless it arises:

- between two or more PEs of the same entity, or
- under a structured arrangement (in this case, even unrelated parties may come within the scope of the hybrid mismatch rules)³⁵.

DEFINITION OF ASSOCIATED ENTERPRISES:

According to Article 168ter (1) No. 17 of the LITL, the term “associated enterprise” is defined as follows:

- an entity in which the taxpayer directly or indirectly holds a participation of at least 50% in terms of voting rights or capital ownership, or is entitled to receive at least 50% of an entity’s profits;
- an individual or an entity that directly or indirectly holds a participation in the Luxembourg corporate taxpayer of at least 50% in terms of voting rights or capital ownership, or is entitled to receive at least 50% of the taxpayer’s profits;
- an entity that is part of the same consolidated group for financial accounting purposes (i.e. a group consisting of all entities which are fully included in consolidated financial statements drawn up in accordance with the International Financial Reporting Standards (IFRS) or the national financial reporting system of an EU Member state);
- an entity in which the taxpayer has a significant influence in the management exercises effective control or an entity that has a significant influence in the management which exercises effective control over the taxpayer.

³⁵ Article 168ter (2) of the LITL.
Where an individual or an entity that directly or indirectly holds a participation of at least 50% in terms of voting rights or capital ownership in the taxpayer and one or several other entities, all these entities including the taxpayer are considered as associated enterprises within the meaning of Article 168ter of the LITL.

With regard to hybrid mismatches involving hybrid financial instruments within the meaning of Article 168ter (1) No. 2 a) of the LITL, the threshold requirement of 50% is reduced to 25%.

When determining the percentage of an indirect participation, the shareholding percentages through the chain must be multiplied with each other.

AGGREGATION OF INTERESTS

In certain circumstances, the shareholding percentages of otherwise unrelated parties have to be aggregated for the purposes of the related party test. More precisely, a person who acts together with another person in respect of voting rights or capital ownership of that 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.76

The purpose of the “acting together” concept is to prevent taxpayers from avoiding the related party test being met by transferring their voting interest or equity interests to another person who continues to act under their direction in relation to those interests.

The other situation targeted by the acting together concept is where a taxpayer or a group of taxpayers who individually hold minority stakes in an entity, enter into arrangements that would allow them to act together (or under the direction of a single controlling mind) to enter into a hybrid mismatch arrangement with respect to one of them.76

According to the Final Report on BEPS Action 12, two persons will be treated as acting together in respect of ownership or control of any voting rights or equity interests if:

a) they are members of the same family, including a person’s spouse, the relatives of that person and their spouses. A relative includes grandparents, parents, children, grandchildren and brothers and sisters (including adopted persons and step-siblings) but it would not include indirect or non-lineal descendants such as a person’s nephew or niece;

b) one person regularly acts in accordance with the wishes of the other person. This will be the case when the person is legally bound to act in accordance with another’s instructions or if it can be established that one person is expected, or typically acts, in accordance with another’s instructions;

c) they have entered into an arrangement that has material impact on the value or control of any such rights or interests. This test covers both arrangements concerning the exercise of voting interests (such as the right to participate in any decision-making) and regarding beneficial entitlements (such as entitlement to profits or eligibility to participate in distributions) or arrangements concerning the ownership of those rights (such as agreements or options to sell such rights).

This test is intended to capture arrangements that are entered into with other investors and does not cover arrangements that are simply part of the terms of the equity or voting interest or operate solely between the holder and the issuer.

Moreover, the arrangement regarding the ownership or control of voting rights or interests must have a material impact on the value of those rights or interests. This materiality threshold prevents investors from having their equity or voting interests treated as part of a common holding arrangement simply because investors are a party to a commercially standard shareholder or investor agreement that does not have a material impact on the ability of a holder to exercise ownership or control over the equity or voting interest; or

d) the ownership or control of any such rights or interests are managed by the same person or group of persons. This test may pick up a number of investors whose investments were managed under a common investment mandate or partners in an investment partnership.77

INVESTMENTS FUNDS

Luxembourg is a global hub for the structuring of Alternative Investments in and throughout Europe. Therefore, the question as to how the concept of acting together applies in a fund context is of crucial importance. In this regard, Article 168ter of the LITL provides for a de minimis rule.78

Investment funds can be defined as collective investment vehicles which are created for the purpose of gathering investors’ capital and investing that capital in a portfolio of assets in accordance with a defined investment policy for the benefit of those investors. The definition of investment funds is broad and includes Luxembourg and foreign funds, close-ended and open-ended funds, listed and unlisted funds irrespective of the legal form thereof. Investment funds may be divided into two broad categories:

• Undertakings for collective investments in transferable securities (UCITS) that invest into financial instruments such as stocks, bonds and other securities; and

• Alternative Funds that are created for different types of investments such as Private Equity, Venture Capital, Real Estate and Infrastructure investments.

According to the commentaries to the ATAD 2 bill, investors in a fund generally do not have effective control over the investments made by the fund that has to invest the contributions of investors in accordance with the fund’s investment policy. Therefore, Article 168ter LITL provides for a safe harbour rule according to which an investor (be it an individual or an entity) that owns directly or indirectly less than 10% of the shares or units in a fund (and that is entitled to less than 10% of the fund’s profits) is considered not to act together with the other investors, unless proven otherwise. Here, the burden of proof would be on the Luxembourg tax authorities to evidence that investors are acting together within the meaning of this concept.

Hence, in an investment fund context, the ownership of stakes below 10% should in principle not be relevant when considering a potential aggregation of interests as a consequence of the “acting together” concept.79 Moreover, when investors in a fund own 10% or more of the shares or fund units (or are entitled to 10% or more of the fund’s profits), it has to be analysed on a case-by-case basis whether or not two or more investors are acting together for the purpose of the related party test. Here, the burden of proof that the acting together concept does not apply is on the taxpayer. However, there is no presumption that investors with 10% or more investments would be acting together.
EXAMPLE: THE LUXEMBOURG INVESTMENT FUND

A Luxembourg Reserved Alternative Investment Fund (RAIF) invests into pan-European real estate assets. The fund is managed by a Luxembourg Alternative Investment Fund Manager (AIFM) that makes investments in accordance with the Fund’s investment policy as outlined in the prospectus. Thus, the RAIF qualifies as an investment fund for the purposes of the de minimis rule.

The investments of the RAIF are made via a Luxembourg master company (LuxMasterCo) that operates as the fund’s investment platform and via separate property companies (Lux or local PropCo) that are financed by a mixture of equity and debt instruments (interest-bearing loans, “IBL”).

The investors in the fund are institutional investors from several jurisdictions with shareholdings ranging from 2 to 9 per cent. The investors are not actively involved in the investment process (other than confirming the investment policy from time to time) and there exists no special relationships between the investors.

Here, the shareholdings of the investors owning less than 10% should not be added together in accordance with the de minimis rule. While the shareholding percentages might need to be aggregated if the Luxembourg tax authorities can prove that the investors are acting together, in the present case there exist no indication that investors are acting together within the meaning of Art. 168ter (1) No. 18 of the LITL.

In practice, investment funds may involve more than one fund vehicle. Given that institutional investors (insurance companies, pension funds, etc.) have to comply with various regulatory requirements, investment managers may be inclined to accommodate these requirements through the implementation of additional pooling vehicles (so-called “feeder funds”) that collect the capital from investors and invest in the main fund. Feeder funds may be established in Luxembourg or abroad in the form of a corporate entity (a corporate fund or standard company), a partnership (a transparent fund or standard partnership) or a contractual fund (e.g. FCP).

The question arises how the de minimis rule applies in case of feeder funds. When a feeder fund is classified as opaque from a Luxembourg tax perspective, the related party test (i.e. whether or not the 50% threshold requirement is exceeded) should be applied in regard to the feeder fund. Nevertheless, the inclusion of the income at the level of the feeder fund or the tax (exempt) status of the feeder fund may discharge the application of the hybrid mismatch rules.

In contrast, when the feeder fund is classified as transparent from a Luxembourg tax perspective (for example, a partnership or FCP), the de minimis rule should be applied in regard to the investors in the feeder fund (rather than the feeder vehicle itself). Therefore, investors in the feeder vehicle that indirectly own less than 10% in the main fund should not be aggregated for the purposes of the related party test.

As regards investors that indirectly own 10% or more in the main fund, it has to be analysed on a case-by-case basis whether or not the acting together concept applies. The fact that the feeder fund is managed by a general partner or a management company does not, on its own, suffice to trigger the application of the acting together concept.

EXAMPLE: THE FEEDER FUND

Based on the previous example, it is assumed that 60% of the investments in the RAIF are made directly by institutional investors, whereas 40% of the investments are made via a Luxembourg fund in contractual form (fonds commun de placement, “FCP”) that operates as a feeder fund for those investors that have a preference for such vehicle from a foreign regulatory perspective.

While the FCP owns 40% in the RAIF (and therefore LuxMasterCo), it is assumed that the investors investing into the FCP indirectly own less than 10% in the RAIF (applying a look-through approach).

The institutional investors that directly invest into the RAIF should not be aggregated as the de minimis rule applies. There further exists no indication that these investors would be acting together.

From a Luxembourg tax perspective, the FCP feeder fund is treated as transparent. Therefore, it is not the 40% investment of the FCP but the individual investments of the investors in the FCP that have to be analysed. As each of the investors in the FCP owns indirectly less than 10%, the de minimis rule should apply in this case.

As a result, none of the investors owns 10% or more in the RAIF and the participations of different investors should not be aggregated for the purposes of the related party test.

STRUCTURED ARRANGEMENT

The hybrid mismatch rules also apply to any person regardless of any related party test who is a party to a “structured arrangement” regardless of any association with the other party thereto80. A “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 mismatch81.

The test as to whether an arrangement is structured is objective and does not consider the parties’ intention82. Therefore, if the tax benefit of the mismatch is priced into the arrangement or if a reasonable person, looking at the facts of the arrangement, would otherwise conclude that it was designed to engineer a mismatch in tax outcomes, then the arrangement should be caught by the definition83.

81 Article 168ter (1) No. 16 of the LITL.
The hybrid mismatch will be priced into the terms of the arrangement if the mismatch has been factored into the calculation of the return under the arrangement (i.e. the taxpayer benefits from the tax advantage). This test looks at the actual terms of the arrangement with a view to determine whether the pricing of the transaction is different from what would have been agreed had the mismatch not arisen.

In contrast, the “designed to produce a hybrid mismatch” test is a wider test that looks at:

- the relationship between the parties;
- the circumstances under which the arrangement was entered into;
- the steps and transactions that were undertaken to put the arrangement into effect, and
- the terms of the arrangement itself and the economic and commercial benefits of the transaction.

According to the Final Report on BEPS Action 2, facts and circumstances that indicate that an arrangement has been designed to produce a hybrid mismatch include any of the following:

a) an arrangement is designed, or is part of a plan, to create a hybrid mismatch. This assumes a person with material involvement in, or awareness of, the design of the arrangement (such as a tax adviser) has identified, before the arrangement was entered into, that it will give rise to a mismatch outcome;

b) an arrangement that incorporates a term, step or transaction used in order to create a hybrid mismatch. Here, a term, step or transaction will be treated as inserted into an arrangement to produce a mismatch outcome if that mismatch would not have arisen in the absence of that term, step or transaction and where there was no substantial business, commercial or other reason for inserting that term into the arrangement or undertaking that step or transaction;

c) an arrangement that is marketed, in whole or in part, as a tax-advantaged product where some or all of the tax advantage derive from the hybrid mismatch. This would be analysed based on written, electronic or oral communication provided to the parties;

d) an arrangement that is primarily marketed to taxpayers in a jurisdiction where the hybrid mismatch arises. Here, the fact that the arrangement is also available to taxpayers in other jurisdictions who do not benefit from the mismatch will not prevent that transaction from being treated as part of a structured arrangement if the majority of the arrangements, by number or value, are entered into with taxpayers located in jurisdictions that do benefit from the mismatch;

e) an arrangement that contains features that alter the terms under the arrangement, including the return, in the event that the hybrid mismatch is no longer available (i.e. this would be an indication that the benefit of the hybrid mismatch has been priced into the arrangement), or

f) an arrangement that would produce a negative return absent the hybrid mismatch. In these circumstances, it would be uneconomic for the taxpayer to enter into the arrangement absent the benefit under the hybrid mismatch.

The structured arrangement definition does not, however, apply to a taxpayer who is not a party to the arrangement. To be considered as a party to an arrangement requires that a person has a sufficient level of involvement in the arrangement to understand how it has been structured and what its tax effects might be.

Nevertheless, this test is not intended to impose an obligation on that person to undertake additional due diligence on a commercial transaction over and above what would be expected of a reasonable and prudent person.

7.1.2 OBJECTIVE SCOPE

TARGETED HYBRID MISMATCHES

Article 168ter of the LITL targets four categories of hybrid mismatches:

- hybrid mismatches that result from payments under a financial instrument, including hybrid transfers;
- hybrid mismatches that are a consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment (PE), including as a result of a payment to a disregarded PE;
- hybrid mismatches that result from payments made by a hybrid entity to its owner or deemed payments between the head office and PE or between two or more PEs; and
- double deduction outcomes resulting from payments made by a hybrid entity or PE.

Article 168ter (3) No. 3 of the LITL further targets so-called imported hybrid mismatches that shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of EU Member States through the use of a non-hybrid instrument.

Finally, Article 168ter (4) of the LITL provides for rules that aim at neutralizing double deduction outcomes in case of tax residence mismatches (i.e. when an entity is resident for tax purposes in two or more jurisdictions).

7.1.3 TERRITORIAL SCOPE

Luxembourg anti-hybrid rules (article 168ter of the LITL) apply to cross-border hybrid mismatches where one of the parties involved is a Luxembourg taxpayer. For that purpose, a taxpayer is Luxembourg entity established in the legal form of a Luxembourg company subject to corporate income tax (article 159 of the LITL) or a Luxembourg permanent establishment of non-resident companies (article 160 (1), 2° of the LITL).

Luxembourg anti-reverse hybrid rule (article 168quarter of the LITL) applies to reverse hybrid entities defined as entities incorporated or established in Luxembourg that are treated as transparent for Luxembourg tax purposes (article 175 of the LITL), as for example, limited partnerships such as SCS or SCSp.

7.2 LUXEMBOURG ANTI-HYBRID RULES

Article 168ter of the LITL applies in case of mismatch outcomes which comprise deductions without inclusion and double deductions.

DEDUCTION WITHOUT INCLUSION (D/NI)

Deductions without inclusion are defined as the deduction of a payment (or deemed payment between the head office and PE or between two or more PEs) 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. In this regard, the payee jurisdiction is any jurisdiction where that payment or deemed payment is received or treated as being received under the laws of any other jurisdiction.

If the payment is brought into account as ordinary income in at least one jurisdiction, there will be no mismatch for the rule to apply. In more complex situations (involving several entities), the concept of inclusion may require an economic interpretation.
For example, in case of US investors that treat companies in a chain of companies as transparent for US tax purposes (i.e. check-the-box election), the inclusion of the income of the operational subsidiary at the level of the US investors should suffice to discharge the application of the hybrid mismatch rules as there is no mismatch outcome from an economic perspective.98

The payment is deemed to be included in the taxable income if it is subject to tax at the taxpayer’s standard rate regardless of the timing of the inclusion (unless a specific provision requires an inclusion within a certain time frame).99 This should be the case if the payment does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular types of payments.

However, inclusion does not require effective taxation. Thus, if the payee has tax losses that offset the income related to the payment, the latter will be considered as included for the purposes of the hybrid mismatch rules.100 Moreover, the reduction of the tax by a credit granted by the payee jurisdiction for withholding tax or other taxes imposed by the source jurisdiction on the payment does not jeopardize the inclusion of the payment.101

DOUBLE DEDUCTION (DD)

Double deductions are defined as 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 a PE, the payer jurisdiction is the jurisdiction where the hybrid entity or PE is established or situated.102

However, as no mismatch outcome arises when a (double) deduction is offset against dual inclusion income (that is income that is included in the tax base in two jurisdictions), the hybrid mismatch rules only apply in case of double deductions that are offset against non-dual inclusion income. 7.3 EXCLUSIONS FROM LUXEMBOURG ANTI-HYBRID RULES

The purpose of Article 168ter of the LITL is the neutralisation of mismatch outcomes that occur in specific hybrid mismatch situations. At the same time, the hybrid mismatch rules should not create economic double taxation.103 Therefore, the scope of the hybrid mismatch rules is limited as follows:

DEDUCIBLE PAYMENTS

The hybrid mismatch rules are exclusively targeted at “deductible payments”. Thus, non-deductible payments such as interest expenses incurred in relation to tax exempt income may not come within the scope of Article 168ter of the LITL.

TIMING DIFFERENCES

Jurisdictions may use different tax periods and have different rules for recognising when items of income or expenditure have been derived or incurred. However, timing differences should generally not be treated as giving rise to mismatches in tax outcomes as long as the income is included within a reasonable period of time.104

A payment under a financial instrument is deemed to be included within a reasonable period of time if such 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.105

Alternatively, it has to be evidenced by the taxpayer that 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 adhere to the arm’s length principle.

The inclusion of income does not require effective taxation though. Instead, the mere inclusion in the ordinary income of the payee(s) suffices irrespective of whether or not the income is offset by tax losses incurred in the same or previous tax periods.

TAX STATUS OF THE PAYEE

A payment should not be treated as giving rise to a hybrid mismatch if the non-inclusion of a payment would have arisen in any event due to the tax status of the payee under the laws of the payee jurisdiction.

Accordingly, the following payments should be deemed not to give rise to a deduction without inclusion outcome:

• payments to a taxpayer that is resident in a jurisdiction that does not levy corporate income tax;
• payments to a taxpayer that is resident in a jurisdiction with a pure territorial regime where the income is excluded or exempt from foreign source income; and
• payments to tax-exempt investors such as investment funds, pension funds or sovereign wealth funds that benefit from a tax exemption in their state of residence.

When the tax status of the payee discharges the application of the hybrid mismatch rules, it is not necessary to demonstrate that no hybrid mismatch would have arisen if the payee was a fully taxable company (also referred to as “counterfactual test”).

Furthermore, as regards payments under financial instruments, a payment should not be considered as giving rise to a mismatch outcome if the latter is solely due to the fact that the instrument is held subject to the terms of a special regime.106

104 See page 16 of the Opinion of the Luxembourg State Council of 10 December 2019; as a general rule, mere timing differences should not trigger the application of the hybrid mismatch rules.
107 See recital 30 of ATAD 2.
108 See recital 30 of ATAD 2.
109 See recital 30 of ATAD 2.
110 See recital 30 of ATAD 2.
111 See recital 30 of ATAD 2.
112 See recital 30 of ATAD 2.
DUAL INCLUSION INCOME
With regard payments by a hybrid entity\textsuperscript{113}, deemed payments between a head office and a PE\textsuperscript{114} and double deductions\textsuperscript{115}, the hybrid mismatch rules only apply if and to the extent a deduction is set-off against income that is not dual inclusion income (that is any item of income that is included under the laws of both jurisdictions where the mismatch outcome arises). Thus, the deduction of payments from dual-inclusion income does not trigger the application of the hybrid mismatch rules.

TRANSFER PRICING ADJUSTMENTS
Differences in tax outcomes that are solely attributable to transfer pricing adjustments do not fall within the scope of the hybrid mismatch rules. Therefore, downward adjustments that are treated as deductible expenses by a taxpayer should not trigger the application of the hybrid mismatch rules even if no corresponding transfer pricing adjustment is made in the other jurisdiction\textsuperscript{116}.

ALLOCATION OF TAXING RIGHTS UNDER TAX TREATIES
Any adjustment required under the hybrid mismatch rules should in principle not affect the allocation of taxing rights between Contracting States under an applicable tax treaty. This confirms that tax treaty law is generally superior to the domestic tax laws of the Contracting States.\textsuperscript{117}

7.5 HYBRID MISMATCHES COVERED BY LUXEMBOURG ANTI-HYBRID RULES
Article 16Bbis (1) No. 2 of the LITL specifies a number of hybrid mismatch situations that come within the scope of the hybrid mismatch rules.

The definition of financial instrument is very broad and comprises 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, including hybrid transfers.\textsuperscript{118}\textsuperscript{119}\textsuperscript{120}

A hybrid transfer is any arrangement to transfer a financial instrument where the underlying return on the transfer of the financial instrument is treated for tax purposes as derived simultaneously by more than one of the parties to the arrangement. The laws of two jurisdictions take opposing views on whether the transferor and transferee have ownership of the underlying asset as a consequence of the economics of the transaction and the way it is structured. In this regard, ownership refers to the economic ownership of the payment as opposed to the legal ownership of the asset itself.\textsuperscript{121}

The payment under the hybrid transfer may give rise to a deduction without inclusion outcome where the payer claims a deduction while the payee treats the payment as a return on the underlying instrument itself (on which grounds the payment is excluded or exempt from taxation). Hybrid transfers may further result in the generation of surplus tax credit for the tax withheld at source on the underlying instrument.\textsuperscript{122}

While a hybrid transfer may arise in the context of an ordinary sale and purchase agreement when there is a conflict in the determination of the timing of the asset transfer, the hybrid transfer rules are particularly targeted at sale and re-purchase (Repo) and security lending transactions where the rights and obligations of the parties are structured in such a way that the transferor remains exposed to the financing or equity return on the financial instrument transferred under the arrangement.\textsuperscript{123} As hybrid transfers are treated as a type of financial instrument, a deduction without inclusion outcome under a hybrid transfer will only be subject to adjustments if and to the extent the mismatch can be attributed to differences in the tax treatment of the arrangement under the laws of the payer and payee jurisdictions.\textsuperscript{124}

A payment representing the underlying return on a transferred financial instrument shall not, however, give rise to a hybrid mismatch where the payment is made by a financial trader under an on-market hybrid transfer provided that the payer jurisdiction requires the financial trader to include all amounts received as income in relation to the transferred financial instrument.\textsuperscript{125} On-market hybrid transfers are defined as 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.\textsuperscript{126}

RULES
According to article 16Bter (3), al2, 2° of the LITL, since the hybrid mismatch gives rise to a deduction without inclusion outcome, if Luxembourg is the payer jurisdiction, it shall deny the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another country.

• if Luxembourg is the payee jurisdiction, it shall include the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction\textsuperscript{127} or the mismatch is neutralized in another country.

113 Article 168ter (1) No. 2 e) of the LITL
114 Article 168ter (1) No. 2 f) of the LITL
115 Article 168ter (1) No. 2 g) of the LITL
116 See section 2.1.5.
117 Article 16Bter (1) No. 11 of the LITL
118 Article 16Bter (1) No. 13 of the LITL
119 See Final Report on BEPS Action 2, p. 38, No. 72
120 See recital 13 of ATAD 2; see Final Report on BEPS Action 2, p. 26, No. 23.
121 See Final Report on BEPS Action 2, p. 38, No. 73.
123 Article 16Bter (1) No. 2 of the LITL
124 Article 16Bter (1) No. 14 of the LITL
125 The denial of the deduction in the payer jurisdiction shall result either from a declaration of the payer or from certain and precise elements.
126 The definition of financial instrument is very broad and comprises 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, including hybrid transfers.
127 A hybrid transfer is any arrangement to transfer a financial instrument where the underlying return on the transfer of the financial instrument is treated for tax purposes as derived simultaneously by more than one of the parties to the arrangement. Here, the laws of two jurisdictions take opposing views on whether the transferor and transferee have ownership of the underlying asset as a consequence of the economics of the transaction and the way it is structured. In this regard, ownership refers to the economic ownership of the payment as opposed to the legal ownership of the asset itself.
128 The payment under the hybrid transfer may give rise to a deduction without inclusion outcome where the payer claims a deduction while the payee treats the payment as a return on the underlying instrument itself (on which grounds the payment is excluded or exempt from taxation). Hybrid transfers may further result in the generation of surplus tax credit for the tax withheld at source on the underlying instrument.
129 While a hybrid transfer may arise in the context of an ordinary sale and purchase agreement when there is a conflict in the determination of the timing of the asset transfer, the hybrid transfer rules are particularly targeted at sale and re-purchase (Repo) and security lending transactions where the rights and obligations of the
A payment generates a deduction without inclusion outcome if the payment is not included within a reasonable period of time.

The “reasonable period of time” criterion with regard to the inclusion of the income is deemed to be met when:

- 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

- 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 adhere to the arm’s length standard.

Notably, if the deductible payment is brought into account as ordinary income in at least one jurisdiction, there will be no mismatch for the rule to apply to.

Moreover, the hybrid financial instrument rule should only apply where the mismatch in tax treatment is attributable to the terms of the instrument. In contrast, where the tax relief 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 tax regime, the payment under a financial instrument should not give rise to a hybrid mismatch.

As a consequence, the payment will be deductible in State B (D), whereas the payment will not be included in the taxable basis of A-Co in State A (NI), resulting in a deduction without inclusion outcome (D/NI).

In a mere EU context, payments under financial instruments should not give rise to hybrid mismatch outcomes within the meaning of article 168ter of the LITL. This is because EU 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, as amended (the “Parent-Subsidiary Directive”) already required EU Member States to implement an anti-abuse provision under which the tax exemption applicable to dividend income is denied when these payments are deductible at the level of the paying EU subsidiary. Thus, this provision eliminates potential mismatch outcomes through the linking of the tax treatment in the payee jurisdiction to that in the payer jurisdiction.

**EXCEPTION**

A payment under a financial instrument or a hybrid transfer does not give rise to a hybrid mismatch where the non-inclusion in the payee jurisdiction is solely due to (i) the tax status of the payee or (ii) the fact that the instrument is held subject to the terms of a special tax regime.

In order to interpret the two exceptions indicated above, reference can be made to BEPS Action 2 Report, which is explicitly mentioned both by recital 28 of ATAD 2 and in the commentary to the draft law introducing article 168ter of the LITL.

**EXAMPLES**

**THE HYBRID FINANCING INSTRUMENT**

A company resident in State A (A-Co) has a 100% participation in a company resident in State B (B-Co). A-Co finances B-Co with a subordinated loan (IBL) that is classified as a debt instrument under the laws of State B. In contrast, under the laws of State A, the loan is classified as an equity interest and the payments under the instrument benefit from an exemption under the domestic participation exemption regime.

This anti-abuse rule has been included in Article 166 (2bis) of the LITL. This type of hybrid mismatch involves a so-called reverse hybrid entity which is any entity that is treated as transparent under the laws of the jurisdiction where it is established but as a separate entity (i.e. opaque) under the laws of the jurisdiction of the investor(s). Thus, a deductible payment made to a reverse hybrid entity may give rise to a mismatch in tax outcomes where that payment is neither included in ordinary income in the establishment jurisdiction of the hybrid entity nor in the jurisdiction of any investor therein. As for the other hybrid entity payments rules, the reverse hybrid rule can apply to a broad range of deductible payments including interest, royalties, rents and fees for services.

**RULES**

According to article 168ter (3), al2. 2° of the LITL, since the hybrid mismatch gives rise to a deduction without inclusion outcome,

- if Luxembourg is the payer jurisdiction, it shall deny the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another country.

- if Luxembourg is the payee jurisdiction, it shall include the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in
the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction\textsuperscript{139} or the mismatch is neutralized in another country.

**EXCEPTION**

The scope of this hybrid mismatch rule is, however, limited twofold:

- First, if the payment is treated as taxable income in at least one jurisdiction (including the potential application of CFC rules at the level of a parent company), there will be no hybrid mismatch within the meaning Article 168ter (1) No. 2 b) of the LiTIL.
- Second, if the payment is not treated as taxable income in any jurisdiction, this rule should not apply unless the payment would have been included as ordinary income if it had been paid directly to the investor (i.e. the interposition of the reverse hybrid entity must have been necessary to bring about the mismatch in tax outcomes). In other words, the hybrid mismatch rules do not apply if the payment would not be taxed in any case due to the tax-exempt status of the payee under the laws of any payee jurisdiction (i.e. the payee jurisdiction does not levy corporate income tax, the payee jurisdiction adopted a territorial system, the payee is tax exempt in another country).

**EXAMPLE**

Payments to a hybrid entity

A company resident in State A (A-Co) owns two participations in entities resident in State B (B-Co 1 and B-Co 2, respectively). While B-Co 2 is a corporate taxpayer under the domestic tax law of State B, B-Co 1 is treated as fiscally transparent. Under the laws of State A, both subsidiaries are treated as opaque from a tax perspective.

Thus, B-Co 1 is a hybrid entity within the meaning of the hybrid mismatch rules (i.e. a reverse hybrid entity). B-Co 1 finances B-Co 2 with an interest-bearing loan (IBL).

In this example, the interest paid by B-Co 2 to B-Co 1 is tax deductible (D) at the level of B-Co 2. However, neither at the level of B-Co 1 nor at the level of A-Co, the interest payment is included in the taxable income (NI), resulting in a deduction without inclusion outcome (D/NI).

**Example: Investor resident in an offshore jurisdiction**

Based on the previous example, if A-Co were tax resident in a jurisdiction that does not levy corporate income tax, the direct payment to A-Co would not be taxable and, therefore, the hybrid mismatch rule would not apply.

In the hands of the payer, unless the mismatch outcome is the result of differences in the allocation of payments between the head office and the PE (or between two or more PEs of the same entity) under the laws of the jurisdictions where the entity operates.

**EXCEPTION**

The definition of hybrid mismatch should only apply when 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 (i.e. the payee jurisdiction does not levy corporate income tax, the payee jurisdiction adopted a territorial system where the payment is treated as non-taxable foreign source income or the payee is tax exempt).

**PAYMENT TO AN ENTITY WITH ONE OR MORE PERMANENT ESTABLISHMENT**

**SCOPE**

A hybrid mismatch may further involve a payment to an entity with one or more PEs that gives rise to a deduction without inclusion provided that the mismatch outcome is the result of differences in the allocation of payments between the head office and the PE (or between two or more PEs of the same entity) under the laws of the jurisdictions where the entity operates.

**RULES**

According to article 168ter §3, al2, 2° of the LiTIL, since the hybrid mismatch gives rise to a deduction without inclusion outcome,

- if Luxembourg is the payer jurisdiction, it shall deny the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another country;
- if Luxembourg is the payee jurisdiction, it shall include the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payee jurisdiction\textsuperscript{141} or the mismatch is neutralized in another country.

**EXAMPLE**

Example 1: Payments to an entity with a PE

A company resident in State A (A-Co) has a subsidiary in State C (C-Co) and a PE in State B (B-PE) through which A-Co is financing C-Co with an interest-bearing loan (IBL). State A and State B concluded a tax treaty under which profits attributable to B-PE may be taxed in State B, whereas State A adopted the exemption method for the elimination of double taxation.

In the present example, the interest paid by C-Co to B-PE is deductible in State C (D). It is further assumed that the interest is not included in the tax base of B-PE (NI) since under the domestic tax law of State B, the income is deemed to be attributed to A-Co. In State A, the profits attributable to B-PE are exempt (NI) in accordance with the applicable tax treaty. Hence, the hybrid mismatch results in a deduction without inclusion outcome (D/NI) because of differences in the allocation of payments between the head office and PE.

Example 2: Payments to an entity with a PE

Based on the previous example, if A-Co were resident in a state that does not levy corporate tax, the application of the hybrid mismatch rules would be discharged based on the tax status of the investor.
PAYMENT TO A DISREGARDED PERMANENT ESTABLISHMENT

SCOPE

Hybrid mismatch situations may also involve a disregarded PE which is defined as any arrangement that is treated as giving rise to a PE under the laws of the head office jurisdiction and is not treated as giving rise to a PE under the laws of the other jurisdiction (i.e. the assumed host state of the disregarded PE from the perspective of the head office jurisdiction).

A hybrid mismatch within the meaning of Article 168ter (1) No. 2 d) of the LITL arises when a payment gives rise to a deduction without inclusion as a result of a payment to a disregarded PE. In these circumstances, the deduction without inclusion outcome is generally a result of the non-recognition of the PE in its assumed host state (in accordance with the domestic tax law of the host state) and the exemption of the income attributable to the disregarded PE (from the perspective of the residence state of the enterprise) in accordance with an applicable tax treaty.

RULES

According to article 168ter (3) al2. 2° of the LITL, since the hybrid mismatch gives rise to a deduction without inclusion outcome,

• if Luxembourg is the payer jurisdiction, it shall deny the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another country.

• if Luxembourg is the payee jurisdiction, it shall include the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction145 or the mismatch is neutralized in another country.

Where a hybrid mismatch involves disregarded PE income that is tax exempt in accordance with a tax treaty concluded between Luxembourg and another EU Member State, the income that would otherwise be attributed to the disregarded PE should be included in the taxable income of the Luxembourg taxpayer.144

In this case, there would be no deduction without inclusion outcome and the payment should remain deductible at the level of the payer.145

This provision is limited to disregarded PEs in an EU context and should not apply when the income of a PE is tax exempt in accordance with a tax treaty concluded between Luxembourg and a third country.146

While ATAD 2 provides that any adjustment that are required thereunder should in principle not affect the allocation of taxing rights between jurisdictions laid down under a tax treaty, the inclusion of the income of a foreign PE that should otherwise be tax exempt under a tax treaty may amount to illegitimate tax treaty override. In practice, however, there should be no cases of disregarded PEs in an EU context.

EXCEPTION

Nevertheless, the hybrid mismatch rule should not apply as long as the mismatch would have arisen in any event due to the tax-exempt status of the payee under the laws of any payee jurisdiction (i.e. the payee jurisdiction does not levy corporate income tax, the payee jurisdiction adopted a territorial system where the payment is treated as non-taxable foreign source income or the payee is tax exempt).147

EXAMPLE

PAYMENTS TO A DISREGARDED PE

A company resident in State A (A-Co) has a subsidiary in State C (C-Co) and a PE in State B (B-PE) through which A-Co is financing C-Co with an interest-bearing loan (IBL). State A and State B concluded a tax treaty under which profits attributable to B-PE may be taxed in State B, whereas State A adopted the exemption method for the elimination of double taxation.

The interest paid by C-Co to B-PE is deductible in State C (D). In State A, the profits attributed to B-PE are exempt (NI) under the tax treaty concluded between State A and State B.

In the present example, it is assumed that the interest is not taxable in State B (NI) as A-Co is considered to have no PE in State B (under the domestic tax law of State B). Hence, this hybrid mismatch results in a deduction without inclusion outcome (D/NI) because of differences in the recognition of a PE under the laws of State A and State B.

DISREGARDED PAYMENT MADE BY A HYBRID ENTITY

SCOPE

A hybrid mismatch also exists where payments made by a hybrid entity give 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.148

Where the mismatch outcome is a consequence of the non-allocation of the payment, the payee jurisdiction is the jurisdiction where the payment is treated as being received under the laws of the payer jurisdiction.149

RULES

According to article 168ter (3), al2. 2° of the LITL, since the hybrid mismatch gives rise to a deduction without inclusion outcome,

• if Luxembourg is the payer jurisdiction, it shall deny the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another country.

• if Luxembourg is the payee jurisdiction, it shall include the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another country.

EXCEPTION

No hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction (i.e. the payee jurisdiction does not levy corporate income tax, the payee jurisdiction adopted a territorial system where the payment is treated as non-taxable foreign source income or the payee is tax exempt).151

The deduction in the payer jurisdiction does not result in a deduction without inclusion outcome if it is only offset against dual inclusion income.152

142 The denial of the deduction in the payer jurisdiction shall result either from a declaration of the payer or from certain and precise elements.
143 Article 168ter (3) No. 4 of the LITL.
144 See recital 29 of ATAD 2.
145 See Article 9 (4) No. 5 of ATAD.
146 See recital 19 of ATAD 2.
147 See Final Report on BEPS Action 2, p. 49; see recital 20 of ATAD 2.
148 Article 168ter (1) No. 2 a) of the LITL.
149 See recital 20 of ATAD 2.
150 The denial of the deduction in the payer jurisdiction shall result either from a declaration of the payer or from certain and precise elements.
151 See Final Report on BEPS Action 2, p. 49; see recital 20 of ATAD 2.
An item of income should be treated as dual inclusion income if it is taken into account as income under the laws of both the payer and payee jurisdiction.\(^{153}\)

**EXAMPLE**

**PAYMENTS BY A HYBRID ENTITY**

A company resident in State A (A-Co) has a subsidiary resident in State B (B-Co). A-Co finances B-Co with an interest-bearing loan (IBL). While under the domestic tax law of State A, B-Co is considered to be fiscally transparent, under the domestic tax law of State B, B-Co is considered to be opaque. Accordingly, B-Co is a hybrid entity.

The payment made by B-Co to A-Co is deductible in State B (D), whereas in State A the same payment is disregarded (NI) in view of the transparency of B-Co under the domestic tax law of State A. Hence, this hybrid mismatch results in a deduction without inclusion outcome (D/NI) because of differences in the classification of B-Co under the laws of State A and State B.

**PAYMENT BETWEEN THE HEAD OFFICE AND PERMANENT ESTABLISHMENT**

**SCOPE**

A hybrid mismatch may also exist in case of a deemed payment between the head office and a PE (or between two or more PEs) that 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.\(^{154}\)

When the mismatch outcome is a consequence of the non-allocation of the deemed payment, the payee jurisdiction is the jurisdiction where the payment is treated as being received under the laws of the payer jurisdiction.\(^{155}\)

**RULES**

According to article 168ter (3), a12, 2° of the LITL, since the hybrid mismatch gives rise to a deduction without inclusion outcome,

- if Luxembourg is the payer jurisdiction, it shall deny the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another country.
- if Luxembourg is the payee jurisdiction, it shall include the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction\(^{156}\) or the mismatch is neutralized in another country.

**EXCEPTION**

However, no hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction (i.e. the payee jurisdiction does not levy corporate income tax, the payee jurisdiction adopted a territorial system where the payment is treated as non-taxable foreign source income or the payee is tax exempt).

Moreover, a mismatch outcome would only arise to the extent that the payer jurisdiction allows the deduction in respect of the payment to be set off against an amount that is not dual-inclusion income.\(^{157}\)

**EXAMPLE**

**DEEMED PAYMENTS IN A PE CONTEXT**

A company resident in State A (A-Co) has a PE in State B (B-PE) through which trading activities are performed. State A and State B concluded a tax treaty under which profits attributable to B-PE may be taxed in State B whereas State A adopted the exemption method for the elimination of double taxation. Under the domestic tax law of State B, it is assumed that B-PE is partly financed with interest-free debt and a deemed interest payment is made to A-Co corresponding to the arm’s length interest rate.

The deemed payment by B-PE to A-Co is deductible in State B (D), whereas in State A the same payment is not taken into consideration (NI) in accordance with the applicable tax treaty. Therefore, the deemed payment by B-PE results in a deduction without inclusion outcome (D/NI).

**DOUBLE DEDUCTION OUTCOME**

**SCOPE**

This category of hybrid mismatches concerns situations where double deduction outcomes occur regardless of whether they arise as a result of payments, expenses that are not treated as payments under domestic tax law or as a result of amortisation or depreciation losses.\(^{158}\)

Deductible payments which come within the scope of these rules may include interest payments, royalties, rents and other amounts such as payments for services that may be set-off against ordinary income.\(^{159}\)

A payment results in a hybrid mismatch where the deduction for the payment may be set-off under the laws of both the parent and the payer jurisdiction against income that is not included in the tax base in both jurisdictions (i.e. dual inclusion income). Conversely, no hybrid mismatch will arise to the extent such deduction is set-off only against dual inclusion income.\(^{160}\)

**RULES**

Since the hybrid mismatch gives rise to a double deduction outcome, according to article 186ter of the LITL:

- if Luxembourg is the investor jurisdiction, it shall deny the deduction of the payment in the hands of the investor;
- if Luxembourg is the payer jurisdiction, it shall deny the deduction in the hands of the payer, unless the deduction is denied in the investor jurisdiction.\(^{161}\)

Where a hybrid mismatch results in a double deduction, the mismatch should be neutralised as follows:

- the payment, expenses or losses are not deductible at the level of the taxpayer that is the investor (primary rule); or
- where a payment, expenses or losses are deductible in the jurisdiction of the investor, the payment, expenses or losses are not deductible at the level of the paying taxpayer (secondary rule).\(^{162}\)

Article 168ter (3) of the LITL introduces a linking rule that aligns the tax outcomes in the payer and parent jurisdictions.
When Luxembourg is the investor jurisdiction, the primary rule provides for a denial of the duplicate deduction to the extent it exceeds the taxpayer’s dual inclusion income (i.e. income brought into account for tax purposes under the laws of both jurisdictions where the hybrid mismatch arises). Conversely, when Luxembourg is the payer jurisdiction and the primary rule is not applied by the counterparty jurisdiction, a secondary or defensive rule applies in Luxembourg to prevent a deductible payment against non-dual inclusion income.\textsuperscript{163}

### EXCEPTIONS

No mismatch arises, however, if and to the extent a deduction is set-off against dual inclusion income.\textsuperscript{164} As the hybrid mismatch rules are generally not intended to be affected by timing differences, payments, expenses or losses should remain deductible to offset dual inclusion income in the current tax period and may be carried forward to offset dual inclusion income in subsequent years.\textsuperscript{165} Moreover, when deductions set-off non-dual inclusion income, the tax adjustment should be no more than what is necessary to neutralise the hybrid mismatch and not lead to economic double taxation.\textsuperscript{166}

### EXAMPLE

A company resident in State A (A-Co) has a subsidiary resident in State B (B-Co). B-Co obtained an interest-bearing loan (IBL) from a bank. While under the domestic tax law of State A, B-Co is considered to be opaque under the domestic tax law of State B. In addition, the same interest payment is deductible (D) in State A where B-Co is treated as transparent for tax purposes. Therefore, the interest payments to the bank result in the present example to a double deduction outcome (DD).

### IMPORTED HYBRID MISMATCHES

#### SCOPE

Imported hybrid mismatches shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of EU Member States through the use of a non-hybrid instrument. In other words, the deductible payment in a Member State can be used to fund expenditure incurred in relation to a hybrid mismatch.\textsuperscript{167}

The imported hybrid mismatch rule disadvantages deductions regarding a broad range of payments such as interest, royalties, rents and payments for services if the income from such payments is set-off, directly or indirectly, against a deduction that arises under a hybrid mismatch arrangement in a third state.\textsuperscript{168} The imported mismatch rule applies to both intra-group and structured imported mismatch arrangements.\textsuperscript{169}

A hybrid deduction does not, however, arise to the extent a disregarded or deductible hybrid payment is set-off against dual inclusion income.\textsuperscript{170}

Imported hybrid mismatches have three basic elements:

1) a deductible payment made by a taxpayer that is subject to the hybrid mismatch rules and which is included in the taxable income under the laws of the payee jurisdiction (that is the “imported mismatch payment). Here, the hybrid mismatch rules would not deny the deductibility of this payment in the absence of a direct hybrid mismatch;

2) a deductible payment made by a person that is not subject to the hybrid mismatch rules which directly gives rise to a mismatch outcome (that is a “direct hybrid deduction). This hybrid mismatch is not neutralised in the absence or non-application of hybrid mismatch rules in a third State; and

3) a nexus between the imported mismatch payment and the direct hybrid deduction that shows how the imported mismatch payment has been set-off directly or indirectly against that hybrid deduction. In practice, this tracing exercise may be complex depending on the number of payments and arrangements involved.\textsuperscript{171}

In other words, an imported hybrid mismatch may arise when the domestic tax laws of two third States do not include hybrid mismatch rules that neutralise the effects of a hybrid mismatch and the income derived from a deductible payment incurred in an EU Member State finances the deductions incurred under the hybrid mismatch.

The imported hybrid mismatch rule evidently creates a lot of complexity that starts with the identification of the payment that gives rise to a (direct) hybrid mismatch and continues with the determination as to what extent the deductible payment made under that hybrid arrangement has been funded (either directly or indirectly) out of payments by a taxpayer that are subject to the imported mismatch rule.\textsuperscript{172}

### RULES

Imported hybrid mismatches shift the effect of a hybrid mismatch between parties in third countries (be it intra-group or structured arrangements) into the jurisdiction of EU Member States through the use of a non-hybrid instrument.\textsuperscript{173} To counter such imported mismatches, Article 168ter (3) No. 3 of the LITL provides that payments are not deductible for tax purposes to the extent that such payments directly or indirectly fund deductible expenditure giving rise to a hybrid mismatch through a transaction or a series of transactions between associated enterprises or entered into as part of a structured arrangement.

### EXCEPTION

However, the payment remains deductible to the extent that one of the jurisdictions involved in the transaction (or a series of transactions) has made an equivalent adjustment in respect of such hybrid mismatch. This should generally involve an adjustment in one of the third states concerned.

### EXAMPLE

Imported deduction without inclusion
A company resident in third state A (A-Co) finances its subsidiary resident in third state B (B-Co) with a subordinated loan (IBL (subordinated)). Under the domestic tax law of third state B, the IBL is classified as a debt instrument and related interest expenses are deductible for tax purposes. In contrast, under the domestic tax law of third state A, the IBL is treated as equity and payments received from B-Co are treated as dividends that benefit from a tax exemption in accordance with the participation exemption regime applicable in third state A.
Accordingly, B-Co 1 is a hybrid entity. State B, B-Co 1 is considered to be opaque. transparent, under the domestic tax law of State A, B-Co 1 is considered to be fiscally consolidated basis. companies are taxed in State B on a
formed a fiscal unity for corporate tax (B-Co 1” and “B-Co 2). B-Co 1 and B-Co
Co) and two subsidiaries thereof that are State (EU-Co) is an associated enterprise A company resident in an EU Member State imported double deduction
relation to a hybrid financial instrument. Imported double deduction
A company resident in an EU Member State (EU-Co) is an associated enterprise of a company resident in third state A (A-Co) and two subsidiaries thereof that are resident for tax purposes in third state B (B-Co 1 and “B-Co 2). B-Co 1 and B-Co 2 formed a fiscal unity for corporate tax purposes in third state B. Thus, both companies are taxed in State B on a consolidated basis.

While under the domestic tax law of State A, B-Co 1 is considered to be fiscally transparent, under the domestic tax law of State B, B-Co 1 is considered to be opaque. Accordingly, B-Co 1 is a hybrid entity.

The interest paid by B-Co 1 to the Bank is deductible (D) in third state B given that B-Co is treated as opaque under the domestic tax law of third state B. The interest expenses incurred by B-Co 1 may offset any income realised in the fiscal unity. In addition, the same interest payment is deductible (D) in State A where B-Co 1 is treated as transparent from a tax perspective. Therefore, the interest payments to the bank results in a double deduction (DD).

While the interest expenses in regard to the IBL granted by B-Co 2 to EU Co are generally deductible, in the present example, these payments finance expenditure incurred by B-Co 1 in relation to the bank loan that give rise to a double deduction. Thus, in this case a double deduction that would otherwise be imported to the EU Member State should be neutralised through the application of the imported hybrid mismatch rule.

REVERSE HYBRID MISMATCHES

SCOPE

A reverse hybrid is an entity that is treated as transparent under the laws of the jurisdiction where it is established but as a separate entity (i.e. opaque) under the laws of the jurisdiction(s) of the investor(s). As a consequence, the income of a reverse hybrid may neither be taxable in its establishment jurisdiction (as the income is deemed to be allocated to the investor) nor in the residence state of the investor(s) (where the income of the opaque entity is not included in the taxable income of the investor(s)). As a consequence, the income of a reverse hybrid may neither be taxable in its establishment jurisdiction (as the income is deemed to be allocated to the investor) nor in the residence state of the investor(s) (where the income of the opaque entity is not included in the taxable income of the investor(s)).

The reverse hybrid mismatch rule aims at eliminating double non-taxation outcomes through the treatment of reverse hybrids as resident taxpayers. Article 168quater of the LITL may apply as from 1 January 2022 to all entities within the meaning of Article 175 of the LITL that are established in Luxembourg (in particular, partnerships). Given that these entities are treated as fiscally transparent, their income is for Luxembourg (corporate) income tax purposes allocated to the owners.

However, the reverse hybrid mismatch rule may only apply when one or more investors (that are resident in a jurisdiction or jurisdictions that regard the Luxembourg entity as opaque) have effective control over the Luxembourg entity. This would be the case when the entity is owned by one or more associated enterprises within the meaning of Article 168ter (1) No. 17 of the LITL which hold directly or indirectly a participation of at least 50% in terms of voting rights or capital ownership, or are entitled to receive at least 50% of an entity’s profit.

RULES

When the reverse hybrid mismatch rule applies, the entity is deemed to be a resident taxpayer and its net income is subject to corporate income tax to the extent this income is not subject to (corporate) income tax at the level of the investors (be it in Luxembourg or abroad). The reverse hybrid mismatch rule has no impact on Luxembourg municipal business taxation. Instead, the tax treatment of a Luxembourg partnership depends significantly on the activities performed. Notwithstanding the fact that partnerships are deemed to be transparent for Luxembourg direct tax purposes, Luxembourg partnerships are subject to municipal business tax on profits derived from carrying on a commercial activity within the meaning of Article 14 (1) of the LITL through a PE situated in Luxembourg.

The carrying on of a commercial activity requires cumulatively an independent activity of a permanent character that is carried on with the intent of realizing profits and participation in the general economic life. Moreover, the activity must not qualify as an activity in the area of agriculture and forestry, independent services within the meaning of Article 91 of the LITL (for example, liberal professions) or wealth management.

Where a general partner of a Luxembourg (special) limited partnership is a Luxembourg company owning a stake of at least 5% in the partnership, the latter is deemed to generate commercial income.

The commercial income realized by Luxembourg partnerships is subject to Luxembourg municipal business tax at the level of the partnership.

With regard to net wealth tax, the draft law provides for a specific exemption for entities that are treated as opaque in accordance with the reverse hybrid mismatch rule. Thus, reverse hybrids are not subject to net wealth tax regardless of whether or not such entity is treated as a taxpayer for corporate income tax purposes.
With regard to payments to a hybrid entity (Article 168ter (1) No. 2 b) of the LITL), the reverse hybrid mismatch rule will have the effect that an arrangement that would otherwise give rise to a mismatch outcome should not be subject to any further adjustment under the hybrid mismatch rules. This is because Article 168quarter of the LITL eliminates the deduction without inclusion outcome through the inclusion of the payment in the taxable income of the reverse hybrid.

**EXCEPTION**

The reverse hybrid mismatch rules will not apply if the income derived through the Luxembourg entity is taxable in Luxembourg as domestic income of non-resident taxpayers. This may, in particular, be the case when a Luxembourg partnership performs a commercial activity that results in the constitution of a PE of its non-resident partner(s).

Likewise, when the income would not be taxed in any case due to the tax status of the investor under the laws of the investor jurisdiction, the reverse hybrid mismatch rule should not apply. This might be the case when the investor jurisdiction does not levy corporate income tax, the investor jurisdiction adopted a territorial system where the payment is treated as non-taxable foreign source income or the recipient is tax exempt (for example, pensions funds that benefit from a special tax regime).

The inclusion of income for Luxembourg corporate income taxes should further be limited to amounts that would result in double non-taxation rather than taxing all of the income of the reverse hybrid.

Article 168quarter of the LITL provides a carve-out for collective investment vehicles (CIV) that are often established in the legal form of a partnership (for example, a “société en commandite simple”, “SCS”) or a contractual fund without legal personality (fonds commun de placement” or “FCP). A CIV is defined as an investment fund or a 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.

The commentaries to the draft law specify that the definition of a CIV includes the following types of entities:

- undertakings for collective investment (UCIs) within the meaning of the Law of 17 December 2010 (i.e. both undertakings for collective investment in transferable securities, “UCITS”, within the meaning of part 1 of the UCI Law of 17 December 2010 and non-UCITS or alternative investment funds within the meaning of part 2 of the UCI Law);
- specialised investment Funds (SIFs) within the meaning of the Law of 13 February 2007;
- reserved Alternative Investment Funds (RAIFs) within the meaning of the Law of 23 July 2016; and
- other alternative investment funds within the meaning of law of 12 July 2013 on alternative investment fund managers which do not already fall into one of the previous categories to the extent that they are widely held, hold a diversified portfolio of securities (so as to limit market risks) and are subject to investor protection obligations.

Luxembourg funds established in corporate form benefit from a specific exemption from corporate income tax, municipal business tax and net wealth tax that is provided in the laws governing the respective fund regime. The very same exemptions should apply to Luxembourg investment funds that may otherwise be subject to corporate income tax in accordance with the reverse hybrid mismatch rule. This ensures an equal treatment of all investment funds irrespective of the legal form in which they are established. The choice of a suitable fund vehicle is frequently driven by commercial aspects such as legal flexibility rather than tax reasons.

**EXAMPLE**

**Example 1: Reverse hybrid mismatch**

An investor resident in State A (A-Co) invests in an entity located in State B (B-Co). While B-Co is treated as a transparent entity from the perspective of State B, under the domestic tax law of State A, B-Co is treated as an opaque entity.

Under the domestic tax law of State B, the income of B-Co is not taxed as the income is allocated to the owner of B-Co. In State A, the income of B-Co is not taxed as B-Co is classified as an opaque entity. Thus, the income of the reverse hybrid entity is neither taxable in State B nor in State A.

In these circumstances, assuming that State B is Luxembourg, Article 168quarter of the LITL would require B-Co to be treated as a corporate taxpayer.

**Example 2: The Luxembourg investment fund**

A Luxembourg Reserved Alternative Investment Fund (RAIF) established in the legal form of a special limited partnership (SCSp) makes investments into pan-European infrastructure assets on behalf of its investors which are institutional investors such as pension funds and insurance companies that are resident in different EU Member States.

The first investment is made via a Luxembourg master holding company (LuxMasterCo) that functions as an investment platform for the fund and a Luxembourg property company (LuxPropCo) that acquires the infrastructure project. LuxPropCo is financed by a mixture of equity and debt granted by LuxMasterCo. The interest-bearing loan (IBL) granted by LuxMasterCo to LuxPropCo is financed by an IBL granted by the RAIF to LuxMasterCo.

Notwithstanding how the RAIF is treated from the perspective of the investor jurisdiction(s), the carve-out from the reverse hybrid mismatch rule (Article 168quarter (2) of the LITL) should apply in the present case. Thus, the RAIF should not be treated as a corporate taxpayer in Luxembourg.
DUAL RESIDENCY MISMATCHES

SCOPE

Tax residency mismatches involve a situation where an entity is considered to be resident for tax purposes in two or more jurisdiction (based on the domestic tax laws of these jurisdictions).

A dual resident mismatch may give rise to double deduction outcomes when payments are deductible under the laws of both jurisdictions where the payer is resident. The meaning of deductible payments generally covers an entity’s expenditures such as interest payments, royalties, rents and other amounts such as payments for services that may be set-off against ordinary income under the laws of the payer jurisdiction in the period in which they are treated as made.184

RULES

If a dual residency mismatch occurs, Luxembourg will 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;

• the mismatch is not neutralized in another Country.

If Luxembourg denies the deduction in the hands of an Luxembourg Taxpayer under the dual residency mismatch rule and it derives a dual inclusion income in a subsequent fiscal year, such income will be exempt for income tax purposes up to the amount of the denied deduction.

EXAMPLE

Tax residency mismatch

A company that has its seat in State A is effectively managed in State B (A/B-Co).

On this basis, it is assumed that A/B-Co is is resident for tax purposes in State A and State B in accordance with the domestic tax laws of both jurisdictions. State A and State B did not conclude a tax treaty. A/B-Co obtained a loan from a bank.

The interest paid by A/B-Co to the bank is deductible in State A and State B, resulting in a double deduction (DD).

In a tax treaty context, cases of dual residence are settled through the application of the so-called (corporate) tie-breaker rule that is included in all tax treaties concluded by Luxembourg. According to the tie-breaker rule, an entity that is a resident of both Contracting States shall be deemed to be (only) a resident of the Contracting State in which the entity’s place of management is situated.185 Thus, when the tie-breaker rule applies, there can be no tax residency mismatch.

While the 2017 revision of the OECD Model provides for a new rule regarding the determination of the state of residence in case of dual residence of entities (i.e. determination by mutual agreement) that has been developed as part of the OECD’s work on BEPS Action 6 (Prevention on Tax Treaty Abuse), States are free to keep (or, with regard to new tax treaties, include) a provision that relies on the place of effective management as tie-breaker.186

RULE

When a Luxembourg corporate taxpayer is deemed to be resident for tax purposes in one or more foreign jurisdictions, payments, expenses or losses that are also deductible in the other jurisdiction(s) should not be tax deductible in Luxembourg to the extent that such other jurisdiction(s) allows such payments, expenses or losses to be set off against income that is not dual-inclusion income.187

However, tax residency mismatches should generally not occur in Luxembourg as tax treaties concluded by Luxembourg eliminate tax residency mismatches through the application of the tie-breaker rule.188

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185 Article 4 (3) of the OECD Model (2014 version).
186 See Paragraph 24.5 of the Commentary on Article 4 of the OECD Model Tax Convention (2017 version).
187 Article 168ter (4) of the LITL.
188 Article 4 (3) of the OECD Model.
8 GERMAN IMPLEMENTATION OF THE ATAD INTEREST LIMITATION RULE

8.1 INTRODUCTION
The German legislator has already implemented interest limitation provisions in 2008. The German interest limitation rule is regulated in Sec. 4h German Income Tax Act (EStG) and Sec. 8a German Corporate Income Tax (KStG) and applies to Income, Corporate Income and Trade Tax but only to profit income of a “business”. The interest barrier rule is not applicable e.g. to a non-commercial partnership engaged in asset management.

In 2015, the Federal Fiscal Court held the interest limitation to be in breach of the constitution and has asked the Federal Constitutional Court to give a ruling. Since then the Federal Fiscal Court has suspended the proceedings due to the pending trial before the Federal Constitutional Court. According to the Federal Fiscal Court the interest limitation of exceeding interest expenses of group companies are only deductible for corporate and trade tax purposes to an amount of 30% of the business’ EBITDA. The exceeding interest expense is defined as the excess of interest paid over that received.

Unused EBITDA potential may be carried forward for up to five years to cover future excess interest expenses. Non-deductible interest expenses may be carried forward without time limit and will be deductible from future income. According to sec. 4h para. 5 EStG, the interest-carryforward is subject to the same principles as the loss-carryforward, including curtailment on change of shareholders.

8.2 DETERMINATION OF “INTEREST EXPENSE”
The limitation applies to all interest expenses, wether the debt is granted by a shareholder, related or third party. Interest limitation applies to all kind of capital loans (e.g. fixed and variable-interest loans, typical silent partnerships, participating bonds etc.).

Interest expenses can be defined as costs for these capital loans. This includes accumulation and discounting of liabilities (even first-time discounting of liabilities), early repayment fees and administrative costs.

In case of factoring without assumption of the default risk (so called “false factoring” (unechtes Factoring)) the cessionary has to establish deferred income in his financial accounts for the gap between assigned receivables and payment. Reversing the deferred income of the cessionary leads to interest expense for interest limitation purposes.

Interest expenses which are included in leasing-rates are interest expenses for interest limitation purposes, if the lessee qualifies as beneficial owner of the leased object.

8.3 DETERMINATION OF THE EBITDA
The EBITDA has to be adjusted for tax purposes (taxable EBITDA). The taxable EBITDA is defined as taxable profit (before applying interest-limitation) less interest and trade tax purposes to an amount of more than 10% of the exceeding interest expenses by a (direct or indirect) shareholder who holds shares of more than 25% or a related party.

For corporate taxpayers the “stand-alone” or the “escape clause” shall not apply if a case of so called “harmful shareholder loan” (schädliche Gesellschafterfremdfinanzierung) is given. This requires payments for shareholder loan to an amount of more than 10% of the excess interest expenses by a (direct or indirect) shareholder who holds shares of more than 25% or a related party.

8.4 EXEMPTIONS FROM THE INTEREST LIMITATION RULE
There are three exemptions to the limitation of deductibility regulated in sec. 4h para. 2 EStG. Initially the limitation does not apply where the exceeding interest expenses for the fiscal year are less than €3 million.

The limitation also does not apply where the company is no group-company (stand-alone-clause). Whether a company is a member of a group depends on the treatment according to the respective accounting standards. The respective company is a member of a group if a consolidated financial statement has to be or could be prepared.

If a company is no member of a group, the counter-exemption-rule in sec. 4h para. 3 sentence 6 EStG could be applicable. According to this provision a company is also a group member, if the finance and business policy of more than one company is determined centralized. Pursuant to this provision a group is also deemed to occur if an individual person is the head of the group and holds the shares in his private assets. In this case a wealth management company also can be the head of the group.

Furthermore the limitation does not apply, where the equity of a business that belongs to a group is no more than two percentage points below the equity of the group (escape-clause).

8.5 DEDUCTIBILITY OF INTEREST EXPENSES IN CASE OF TAX CONSOLIDATION (ORGANSCHAFT)
In case of tax consolidation the tax group (Organschaft) is treated as one business for interest limitation purposes. Hence the tax group is no “group” (Konzern) for the purposes of the interest limitation rule. Furthermore the €3 million limit is applicable only once for the whole tax group.

8.6 CONFORMITY WITH ATAD
The German legislation draft for the ATAD-implementation act states no legislative amendments regarding the interest limitation provisions.

On the whole, the German provisions on the interest limitation correspond with the regulations stated in the ATAD. Both the German provision and the ATAD limit the exceeding interest expenses to 30% of the EBITDA. Only the wording in ATAD is different than in the German provisions. While the ATAD uses the phrase “exceeding interest expenses”, the German provisions use the phrase “exceeding interest expenses”. On a literal interpretation the regulation in the ATAD may be broader than the German provision. But in connection with the Letter of the German Federal Ministry of Finance in which the phrase “exceeding interest expenses” is defined more specifically, the German provision shall be compliant with ATAD.

Also the German exemption provisions correspond with the exemptions stated in the ATAD. They both provide a tax exemption limit of €3 million and a stand alone clause (Art. sec. 3 (a) and (b) ATAD). The German provision regarding the interest-carry-forward corresponds with Art. 4 sec. 6 (a) ATAD. However, it is noted that the German interest barrier rule applies to income and corporate taxes of “businesses” whereas the scope of the ATAD Directive addresses “taxpayers that are subject to corporate tax in [...] Member States”.

192 Decision of Tax Court Münster, dated November 17, 2017. Gazette of Tax Court Decisions 2018. 98. However, a different view is taken by the Ministry of Finance which argues that income from the initial recognition of liabilities shall be excluded.
201 In the German version of ATAD „Überschüssige Fremdkapitalkosten“.
9 GERMAN IMPLEMENTATION OF THE ATAD ANTI-HYBRID RULES

9.1 INTRODUCTION

Lost tax revenues through the use of hybrid arrangements (e.g. in the form of hybrid legal forms and/or hybrid financial instruments) were a key issue in Action 2 of the OECD and G20 project to combat Base Erosion and Profit Shifting (BEPS). Legislation governing hybrid mismatch arrangements already existed in Germany prior to the BEPS project, e.g.

- Sec. 8b para. 1 sent. 2 of German Corporate Income Tax Act (CITA) which prevents deduction/non-inclusion of hybrid dividends at the level of the German recipient corporation or
- Sec. 14 para. 1 no. 5 CITA which prevents double deduction of losses in multinational tax groups.

In 2017 the German legislator introduced a provision to prevent double deduction of special business expenses (“Sonderbetriebssausgaben”) incurred by co-entrepreneurships (“Mitunternehmerschaften”). Pursuant to Sec. 4i of German Income Tax Act (ITA), special business expenses are in general not deductible for German tax purposes if they also reduce the tax base in another country. A general anti-hybrid rule, however, has not yet been enacted in Germany.

The German legislator did not address EU Directive 2016/1164 of 12 July 2016 (ATAD) as amended by the EU Directive 2017/952 of 29 May, 2017 regarding hybrid mismatches with third countries (ATAD II) until the end of 2019. On 10 December, 2019, the (long-awaited) draft bill for the implementation of ATAD (ATAD Draft Bill) was published by German Federal Ministry of Finance.

The ATAD Draft Bill provides among other things for the introduction of a new Sec. 4k ITA which regulates the deduction of business expenses in cross-border hybrid arrangements between related parties.

Also, Sec. 8b para. 1 sent. 3 CITA and Sec. 50d para. 9 ITA have been amended. The rules were to apply to income/expenses incurred after 31 December 2019.

Originally, the ATAD Draft Bill was to be passed on 18 December, 2019. However, voting on the bill was postponed until early 2020. It is expected that the legislative procedure will be completed only mid of 2020, however, it cannot be ruled out that the provisions will become effective retroactively as of 1 January 2020. Additionally, further changes and amendments in the legislative procedure cannot be excluded.

9.2 SEC. 4K ITA – OVERVIEW AND STRUCTURE

Sec. 4k ITA implements Articles 9 and 9b of ATAD. It consists of seven paragraphs:

- Sec. 4k para. 1 ITA: deduction/non-inclusion with regard to financial instruments (Art. 2 para. 9 subpara. 1 lit. a of ATAD)
- Sec. 4k para. 2 ITA: deduction/non-inclusion with regard to payments by hybrid entities (Art. 2 para 9 subpara. 1 lit. e of ATAD) and deemed payments between head office and permanent establishment (Art. 2 para. 9 subpara. 1 lit. f of ATAD)
- Sec. 4k para. 3 ITA: deduction/non-inclusion with regard to payments to hybrid entities (Art. 2 para. 9 subpara. 1 lit. b of ATAD), differences in the allocation of payments between head office and/or permanent establishment(s) (Art. 2 para. 9 subpara. 1 lit. c of ATAD) and disregarded permanent establishments (Art. 2 para. 9 subpara. 1 lit. d of ATAD),
- Sec. 4k para. 4 ITA: double deduction (Art. 2 para. 9 subpara. 1 lit. g of ATAD) and tax residency mismatches (Art. 9b of ATAD)
- Sec. 4k para. 5 ITA: “imported mismatches” (Art. 9 para. 3 of ATAD)
- Sec. 4k para. 6 ITA: definitions
  • Scope is limited to transactions between related parties, a company and its PEs and structured arrangements (Art. 2 para. 9 subpara. 2 lit. c. Art. 2 para. 11 of ATAD)
- Sec. 4k para. 7 ITA: treaty override

The rules are to apply to expenses incurred after 31 December 2019 which corresponds to the mandatory ATAD implementation.

The ATAD Draft Bill does not contain rules addressing reverse hybrid mismatches in the meaning of Art. 9a of ATAD II. That was not necessary either, since ATAD II calls for an implementation with regard to such mismatches by 1 January 2022 (cf. Art. 2 para. 3 of ATAD II).

9.3 PAYMENTS RELATING TO FINANCIAL INSTRUMENTS (SEC. 4K PARA. 1 ITA)

Pursuant to Sec. 4k para. 1 ITA, expenses in connection with the use or transfer of capital assets are not deductible to the extent that the income resulting from the expenses is not taxed due to a qualification or attribution of the capital assets that differs from German tax law. E.g. the deduction of interest expenses is denied for German tax purposes if the payment is treated as a (partially) tax-free dividend for the foreign recipient under its applicable law.

Legal consequences of Sec. 4k para. 1 ITA:

→ The payment is not deductible for German tax purposes. (Note: If the dividend is only partially tax exempt, the payment should be pro-rata tax deductible in Germany).

The ATAD Draft Bill explicitly mentions hybrid bonds and profit participation rights [Genussrechte] as typical cases of application of Sec. 4k para. 1 ITA. Substitution payments for dividends and interest within securities lending or repo transactions (i.e. hybrid transfers) are also covered by the regulation.
The non-deductibility of business expenses shall not apply if the respective income is included (i.e., the tax exemption is eliminated) in a future taxation period and the payment conditions meet arm’s-length requirements (cf. Sec. 4k para. 1 sent. 2 ITA which is in accordance with Art. 2 para. 9 lit. a of ATAD). The 12-month period, pursuant to Art. 2 para. 9 subpara. 1 lit. a of ATAD, was not implemented in Sec. 4k para. 1 ITA.

The regulation of Sec. 4k para. 1 ITA supplements the already existing regulation of Sec. 8b para. 1 sent. 2 CITA which addresses the reverse case of a German corporation as recipient. Pursuant to Sec. 8b para. 1 sent. 2 CITA, a dividend (which is in general 95% tax-exempt pursuant to Sec. 8b para. 1 sent. 1, para. 5 sent. 1 CITA) is fully taxable if the respective payment has reduced the taxable income of the issuing corporation.202

Example 1a (Sec. 8b para. 1 sent. 2 CITA): German corporation as recipient

- ForCo receives funds from GerCo. The underlying financial instrument qualifies as debt from Country A’s perspective but as equity from a German tax perspective.
- The payment by ForCo to GerCo for the transfer of the funds is regarded as tax-deductible interest expense in Country A.
- Legal consequences of Sec. 8b para. 1 sent. 2 CITA:
  - The – in general 95% tax-free (Sec. 8b para. 1 sent. 1, para. 5 sent. 1 CITA) – dividend is fully taxable at the level of GerCo.

Sec. 4k ITA links the tax deductibility of interest payments to the actual taxation of the respective income. Therefore, it is questionable whether Sec. 4k para. 1 ITA is applicable if the respective payment is not subject to taxation in the country of the recipient but taxable in a third country. According to our view, the purpose of the provision is to prevent deduction/non-inclusion scenarios. As such a scenario is not given if the respective payment is taxed in a third country, Sec. 4k para. 1 ITA should not be applicable.

Example 1b (Sec. 4k para. 1 ITA)

- Example 1 extended: ForCo A qualifies as CFC (alternatively: transparent or disregarded entity) from Country B’s perspective. The payment is fully taxed in Country B.
  - According to our view, the payment should be deductible for German tax purposes.

9.4 Payments by Hybrid Entities (Sec. 4k Para. 2 ITA)

Pursuant to Sec. 4k para. 2 sent. 1 ITA, expenses of an entity (or a permanent establishment, PE) are not deductible if the income resulting from the expenses is not taxed due to a different tax qualification of the entity (or PE) in the country of the creditor of the income. The provision covers expenses of all kinds, including interest, royalty payments, rental payments or other service fees.

The tax deductibility is only denied if the respective income is actually not taxed. The tax deductibility is therefore not denied if the income is only taxed at a “lower rate” (in contrast to Sec. 4k para. 1 ITA). According to the ATAD Draft Bill, actual taxation is also given if the income is subject to a CFC taxation in a third country.

Example 2 (Sec. 4k para. 2 sent. 1 ITA): general rule

- GerCo qualifies as corporation from a German tax perspective but as transparent entity from Country A’s perspective. ForCo grants GerCo 2 an interest-bearing loan.
- The loan agreement is neglected in Country A, the interest by GerCo 2 to ForCo is therefore not taxed there. Thus, Sec. 4k para. 2 sent. 1 ITA is applicable and the expense is – in general – not deductible at the level of GerCo 2.
- The remuneration by GerCo 1 to GerCo 2 (e.g. service fee) is taxable both in Germany (at the level of GerCo 2) and in Country A (at the level of ForCo as GerCo 2 is transparent from Country A’s perspective).
- Legal consequences of Sec. 4k para. 2 sent. 1 ITA:
  - The payment is not deductible for German tax purposes (unless dual-inclusion income exception is applicable, see below).

Legal consequences of Sec. 4k para. 2 sent. 3 ITA:

- The interest expense is deductible for German tax purposes at the level of GerCo 2 (unless double taxation in Country A is avoided by crediting the German taxes).
- According to ATAD Draft Bill, the exception requires a “quantitative correlation of incongruence and double taxed income”. It shall only apply to the extent the expenses do not exceed the dual-inclusion income. The exception is therefore not applicable to the extend the expenses exceed the dual-inclusion income.
Sec. 4k para. 2 sent. 2 ITA regulates the special case of a foreign asset-managing partnership [vermögensverwaltende Personengesellschaft]. If a partner of such an asset-managing partnership is subject to unlimited (corporate) income tax liability in Germany and the partnership is not treated as a partnership in its country of residence, Sec. 39 para. 2 no. 2 of German General Tax Act (GTA) shall not apply. Sec. 39 para. 2 no. 2 GTA in general leads to a non-recognition of service relationships between an asset-managing partnership and its partners and would cause a deduction/non-inclusion scenario. Sec. 4k para. 2 sent. 2 ITA aims to prevent such a scenario.

Sec. 4k para. 2 sent. 2 ITA is designed as substitute regulation. The rule shall not apply if the respective remuneration is not deductible at the level of the partnership pursuant to that country’s anti-hybrid rules. Example 2b (Sec. 4k para. 2 ITA): foreign asset-managing partnership

- ForCo qualifies as corporation according to Country A’s view but as asset-managing partnership (= vermögensverwaltende Personengesellschaft) from a German tax perspective.
- The service relationship between GerCo and ForCo is neglected pursuant to Sec. 39 para. 2 no. 2 GTA. The remuneration (e.g. royalty, rent, interest, etc.) by ForCo to GerCo is therefore not taxed in Germany.

Legal consequences of Sec. 4k para. 2 sent. 2 ITA:

- The remuneration is taxable in Germany (unless deduction of the remuneration is denied at the level of ForCo under Country A’s anti-hybrid rules).

9.5 PAYMENTS TO HYBRID ENTITIES, DISREGARDED PES AND OTHER HYBRID MISMATCHES (SEC. 4K PARA. 3 ITA)

Pursuant to Sec. 4k para. 3 ITA, expenses are not deductible to the extent that the income resulting from the expenses is not taxed in any country due to an attribution or allocation of the income that differs from German tax law. The provision is designed as a catch-all clause and is applicable i.a. in scenarios in which the receiver of a payment is a hybrid entity or a PE.

Example 3 (Sec. 4k para. 3 ITA): hybrid entity as receiver

- Country A allocates the income to DutchCo. The Netherlands allocate the income to ForCo. The payment by GerCo to DutchCo is therefore not subject to taxation in any country.

Legal consequences of Sec. 4k para. 3 ITA:

- The payment is not deductible for German tax purposes.
- (According to our view, the payment should be deductible if the payment is taxed in Country A, e.g. as a result of the application of Country A’s CFC rules).

It is questionable whether the rule is applicable if the income is not taxed in the country of the recipient but in another country e.g. as a result of a CFC regime (see above Example 3). According to our understanding, a CFC regime (or the US GILTI regime) leads to an actual taxation of the income in another country. Sec. 4k para. 3 ITA should therefore not be applicable.

Example 3a (Sec. 4k para. 3 ITA): PE as receiver

- Germany attributes the payment (= income) to GerCo’s PE whereas Country B attributes the payment to GerCo’s head office.
- The double tax treaty between Germany and Country B provides for an exemption of the PE’s income in Germany. The payment by A Co is therefore not taxed in any country.

Legal consequences of Sec. 4k para. 3 ITA:

- The payment is not exempt from German taxation (treaty override).

9.6 DOUBLE DEDUCTION AND TAX RESIDENCY MISMATCHES (SEC. 4K PARA. 4 ITA)

Sec. 4k para. 1-3 ITA relate to deduction/non-inclusion scenarios whereas Sec. 4k para. 4 ITA addresses double deduction scenarios. Such tax incongruences are often based on tax residency mismatches or payments made by hybrid entities / PEs. Sec. 4k para. 4 ITA, however, does not require a specific hybrid element.

ATAD Draft Bill also implements an anti-hybrid rule with regard to “hybrid branches” (cf. new Sec. 50d para. 9 sent. 1 no. 3 ITA). A taxpayer subject to unlimited (corporate) income tax liability in Germany is not granted with tax exemption of the foreign income under a double tax treaty if the income is not taxable in the other country as a result of an attribution of the respective income that differs from German tax law.

Example 3b (Sec. 50d para. 9 sent. 1 no. 3 ITA): hybrid branch
Pursuant to Sec. 4k para. 4 sent. 1 ITA, expenses are not deductible to the extent that these expenses are also deductible in another tax jurisdiction.

Sec. 4k para. 4 sent. 2 ITA implements the sequence of application of Art. 9 para. 1 lit. a and b of ATAD, according to which the investor jurisdiction (or the parent company’s jurisdiction) shall predominantly deny the deduction. The deduction shall only be denied by the payer jurisdiction if the deduction is not denied by the investor jurisdiction.

In a first step, the regulation of Sec. 4k para. 4 sent. 2 ITA provides for persons subject to unlimited (corporate) income tax liability that the deduction of expenses is denied regardless whether the other jurisdiction has implemented corresponding anti-hybrid rules. In a second step, the deduction of expenses is permitted for corporations subject to unlimited corporate income tax liability (cf. Sec. 1 CITA) if a direct or indirect shareholder of the corporation is not entitled to deduct the expenses in his jurisdiction due to a corresponding anti-hybrid rule.

Sec. 4k para. 4 sent. 2 ITA is not applicable to persons subject to limited (corporate) income tax liability in Germany. Accordingly, anti-hybrid rules of other jurisdictions always take precedence over the German anti-hybrid rules in such scenarios.

Example 4 (Sec. 4k para. 4 sent. 1 and 2 ITA): Germany as payer jurisdiction (hybrid entity)

- ForCo qualifies as corporation from a German tax perspective but as transparent entity from Country A’s perspective. The payment is deductible both in Country A (at the level of ForCo) and in Germany (at the level of GerCo).
- GerCo is subject to unlimited corporate income tax liability.

Legal consequences of Sec. 4k para. 4 sent. 1 and 2 ITA:

→ According to Art. 9 para. 1 of ATAD, Country A as the investor jurisdiction shall predominantly deny the deductibility.

→ As a general rule, the payment is not deductible (cf. Sec. 4k para. 4 sent. 1 ITA). If Country A’s anti-hybrid rules deny the deduction of the payment at ForCo’s level the payment is deductible for German tax purposes at the level of GerCo. If Country A does not deny the deduction of the payment at ForCo’s level the payment is not deductible for German tax purposes (cf. Sec. 4k para. 4 sent. 2 ITA).

→ Dual-inclusion income exception may apply, see below.

Example 4a (Sec. 4k para. 4 sent. 1 ITA): Germany as payer jurisdiction (PE)

ForCo

Country A

Germany

GerCo

3rd party

Payment

→ Germany as payer jurisdiction (PE)

ForCo

Country A

Germany

PE

3rd party

Payment

→ ForCo is subject to limited corporate income tax liability in Germany with the business income generated by the PE. The payment is in general deductible for German tax purposes.

→ Country A does not assume a PE (alternatively: credit method). The payment is deductible in Country A as well.

Legal consequences of Sec. 4k para. 4 sent. 1 ITA:

→ According to Art. 9 para. 1 of ATAD, Country A as the investor jurisdiction shall predominantly deny the deductibility.

→ The payment is not deductible to the extent that these expenses are also deductible in Country A (Sec. 4k para. 1 sent. 1 ITA). Sec. 4k para. 1 sent. 2 ITA is not applicable; Country A’s anti-hybrid rules take precedence over German anti-hybrid rules.

→ Dual-inclusion income exception may apply, see below.

Sec. 4k para. 4 sent. 3 ITA implements the dual-inclusion income exception of Art. 2 para. 9 subpara. 2 lit. b of ATAD. The deduction of expenses is not denied to the extent the expenses are linked to income of the same taxpayer which is included under the laws of both jurisdictions.

Sec. 4k para. 4 sent. 4 ITA implements another exception for persons subject to unlimited (corporate) income tax liability in Germany. If double taxation is avoided by crediting foreign taxes, the deduction according to Sec. 4k para. 4 sent. 1 ITA is only denied to the extent the expenses reduce income in another country that is not subject to German taxation.

Example 4b (Sec. 4k para. 4 sent. 3 and 4 ITA): Germany as investor jurisdiction

ForCo

Country A

Germany

GerCo

3rd party

Payment

→ ForCo qualifies as corporation from Country A’s perspective but as transparent entity from a German tax perspective.

→ Double taxation in Germany is avoided by crediting the foreign taxes against the German tax liability.

Legal consequences of Sec. 4k para. 4 sent. 3 and 4 ITA:

→ According to Art. 9 para. 1 of ATAD, Germany as the investor jurisdiction shall predominantly deny the deductibility.

→ The payment is not deductible for German tax purposes (unless dual-inclusion income exception applies or the payment only reduces income in Country A which is also subject to German taxation).

→ Note: If double taxation in Germany is avoided by exemption method (i.e. by assuming a PE in Country A), the payment is not deductible in Germany anyway (exception: final losses).
9.7 IMPORTED MISMATCHES (SEC. 4K PARA. 5 ITA)

Sec. 4k para. 5 ITA implements Art. 9 para. 3 of ATAD and provides for a non-deductibility of expenses in the case of so-called “imported mismatches”. Such mismatches occur where a tax mismatch arises between other countries and is not eliminated there. The effects of such a tax mismatch are “imported” to Germany. Imported mismatches can be both double deduction and deduction/non-inclusion cases.

Pursuant to Sec. 4k para. 5 sent. 1 ITA, expenses are not deductible in case the taxpayer’s creditor or another creditor has expenses that would be subject to a denial of deductibility under Sec. 4k ITA if the (other) creditor were subject to unlimited (corporate) income tax liability in Germany. Further prerequisite is a link between the taxpayer’s expenses and the creditor’s expenses which lead to the mismatch. According to ATAD Draft Bill an economic connection is not necessary. Instead, it is sufficient that the amount of the taxpayer’s expenses match with the creditor’s expenses.

Sec. 4k para. 5 sent. 2 ITA implements an exception which is in accordance with Art. 9 para. 3 of ATAD. The non-deductibility shall not apply if the tax mismatch is eliminated at the level of a direct or indirect creditor (e.g. on the basis of comparable anti-hybrid rules in the creditor’s jurisdiction). By contrast, the exception does not apply in case the mismatch is eliminated at a subsequent level (e.g. at the level of the foreign parent company of the German taxpayer).

Example 5 (Sec. 4k para. 5 ITA): imported mismatch

<table>
<thead>
<tr>
<th>Country A</th>
<th>GerCo</th>
<th>Country B</th>
</tr>
</thead>
<tbody>
<tr>
<td>ForCo</td>
<td></td>
<td>Country C</td>
</tr>
</tbody>
</table>

- The financial instrument between A Co and B Co qualifies as debt from Country B’s perspective but as equity from Country A’s perspective. The payment by B Co to A Co is therefore deductible at B Co’s level but tax exempted at A Co’s level.
- Any other financial instrument (between GerCo and C Co, C Co and B Co) qualifies as debt from any country’s perspective.
- Country A and Country B have not implemented anti-hybrid rules. Legal consequences of Sec. 4k para. 5 ITA:
  - According to Sec. 4k para. 5 ITA the payment by GerCo to C Co is not deductible for German tax purposes unless the mismatch is eliminated at another level (C Co, B Co, A Co).

9.8 SCOPE OF THE REGULATION AND DEFINITIONS (SEC. 4K PARA. 6 ITA)

The German anti-hybrid rules are codified in the German Income Tax Act, which means that they are applicable to all taxpayers subject to income tax or corporate income tax in Germany. ATAD’s scope is limited to taxpayers that are subject to corporate income tax in a Member State, the German implementation has therefore a broader scope than necessary.

However, the scope of the German anti-hybrid rules is in accordance with Art. 2 para. 9 subpara. 2 lit. c of ATAD - limited to transactions between related parties within the meaning of Sec. 1 para. 2 of German Foreign Tax Act (i.e. a participation of at least 25% or controlling influence is required), transactions between a company and its PEs and structured arrangements (cf. Sec. 4k para. 6 sent. 1 ITA).

Sec. 4k para. 6 sent. 2 ITA implements Art. 2 para. 4 subpara. 3 lit. b of ATAD. 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 the voting rights or capital ownership of that entity that are held by the other person. The aim of this extension is to prevent structuring in which the scope of the anti-hybrid rules is circumvented by distributing voting rights or capital interests to various persons who have a common will to act or pursue similar interests.

Sec. 4k para. 6 sent. 3 ITA defines a structured arrangement in accordance with Art. 2 para. 11 of ATAD. A structured arrangement is to be assumed if the tax advantage resulting from a mismatch is fully or partly included in the terms of the underlying contractual arrangement. According to ATAD Draft Bill this shall be the case if the price of the contractual arrangement differs from the price that would have been agreed if the tax mismatch had not occurred.

In addition, a structured arrangement is assumed if the terms of the underlying contractual agreement or the underlying circumstances indicate that the tax mismatch was to be expected. It is irrelevant whether a taxpayer is aware of the origins of the tax advantage or of his participation in the structured arrangement.

Sec. 4k para. 6 sent. 4 ITA implements an exception to a structured arrangement in accordance with Art. 2 para. 11 of ATAD. The taxpayer shall not be treated as part of a structured arrangement if it cannot reasonably be assumed that the taxpayer was aware of the tax advantage and he proves that he did not participate in any tax advantage. According to ATAD Draft Bill this exception may be applicable if bonds are issued to third parties via a recognized stock exchange and the interest is calculated in such a way that it is also attractive to investors for whom the interest income is taxed regularly.
9.9 CONCLUSIONS

ATAD Draft Bill was published in December 2019 which shall implement ATAD’s anti-hybrid rules in Germany. It is expected that the legislative procedure will be completed in 2020 and it cannot be ruled out that the provisions will become effective retroactively as of 1 January 2020.

The ATAD Draft Bill is mainly in line with the minimum requirements of ATAD. In contrast to ATAD, the dual-inclusion income exception only applies if double taxation is not avoided by credit method. In addition, the ATAD Draft Bill provides for a broader scope of Germany’s anti-hybrid rules as also individuals are affected by them.

The regulations are complex and disputes with the German tax authorities are inevitable as the legal requirements are linked to the tax treatment in other jurisdictions. In particular, it is unclear how proof for the “actual taxation” of income resulting from expenses is to be provided. Evidence for an exception to the “imported mismatch” rule (Sec. 4k para. 5 ITA) seems highly difficult to provide. German tax authorities may therefore try to apply the German anti-hybrid rules excessively. Further changes in the legislative procedure will hopefully provide for guidance and legal certainty.

10 ATAD DIRECTIVES AND THEIR IMPLEMENTATION IN FRANCE: AN INTERNATIONAL APPROACH

10.1 BACKGROUND: A BRIEF SUMMARY ABOUT EU LAW INSTITUTIONAL FRAMEWORK

The aim of the present chapter is analysing ATAD Directives and their implementation from an international tax law approach, more specifically from a EU tax law perspective. The starting point is that EU Court of Justice jurisprudence within the framework of the relationships between EU law and Member States national law in respect of the application of EU Directives, has sensibly evolved.

In the past, the main issue such jurisprudence had addressed was about direct applicability of certain provisions of the EU Directives into national law. The efforts of the Luxembourg Court were the interpretation and analysis of Directives provisions in view of evaluating whether or not such provisions met the qualification of directly applicable norms. Notably, the main conditions of direct applicability of EU Directives were (and are) the following:

1) the terms for the execution of the Directive into national law have expired;
2) the provisions of the Directive are sufficiently detailed and clear so that national law in contrast with them has to be disapplied by domestic Courts.

If EU rules are directly applicable, EU citizens and entities are entitled to have their rights protected by national courts directly under such rules, even if domestic rules are in contrast with them. More recent jurisprudence substantially enriched the principles illustrated above with further issues which confirm the trend by which supremacy of EU law is more and more effective and national law in contrast with EU law has to be disapplied, also in the case where EU rules are not directly applicable.

In various occasions the EU Court of Justice stated that national courts have to evaluate both the letter and the spirit of a EU Directive in order to ascertain that national law has correctly executed such Directive. In fact, EU law must maintain its supremacy towards national law in any event. A further recurring and relevant principle is the principle of effectiveness, by which the rights assigned by EU law must be truly effective, i.e. exercising such rights must not be hindered or made excessively difficult by other kind of provisions (procedural, etc.).

10.2 ATAD AND TAXATION OF INTEREST: RATIONALE IN THE INITIAL STATEMENTS

In the foreword, it is stated that ATAD Directives were enacted with the purpose of creating a minimum common framework of rules within the EU in order to counteract tax evasion and combat base erosion, thus implementing BEPS. The Directives are applicable only to corporate bodies who are subject to corporate income tax; partnerships and other entities are outside the scope of the Directives.

Within such framework, initial statements of Directive 2016/1164 of 12 July 2016 are, as usual, essential to understand and interpret the rationale and the spirit of the Directive, also according to the EU Court of Justice (the ECJ) jurisprudence (in fact initial statements are mentioned many times in the Court rulings in order to ground their conclusions, such as in ECJ -Grand Section 12 July 2005, C-154/05 and C-155/05, Alliance of Natural Health and National Association of Health Stores; ECJ 30 April 2014, C-280/13, Barclays Bank S.A.).
11 FRENCH IMPLEMENTATION OF THE ATAD INTEREST LIMITATION RULE

11.1 INTRODUCTION

Aggressive tax planning jeopardises one of the principles on which a fair and coordinated tax system is based, namely ensuring that tax is paid where profits and value are generated. These new political objectives have been translated by the European Council in the ATAD Directive\(^2\) of 12 July 2016 (ATAD 1), implemented in France through the Finance Bill for 2019 n. 2018-1317 (the Finance Bill). In this respect, the ATAD 1 lays down rules to strengthen the average level of protection against aggressive tax planning by providing a set of general provisions in five specific fields, the first of which is the limitation to the deductibility of interest expense.

Indeed, as reported in the initial statement (6) – in an effort to reduce their global tax liabilities – groups of companies have increasingly engaged in base erosion and profit shifting practices, through excessive interest payments; to this end, an interest limitation rule was necessary to discourage such practices by limiting the deductibility of taxpayers’ exceeding borrowing costs. In particular, ATAD 1 laid down a minimum standard in the form of a general interest limitation rule based on the EBITDA while recognizing that EU Member States could also adopt additional targeted rules against excessive interest financing.

Therefore, Art. 212 bis of the French Tax Code (FTC) that governs the deductibility of interest was redrafted by the Finance Bill, even though the previous one was already in line with the compulsory provisions provided by the ATAD Directive, namely the deductibility of interest expenses (net of interest income) up to 75% of their amount (proportional interest deductible restriction or “Rabot”), or the thin capitalization rules that limit the deductibility of interest paid to related entities beyond specific thresholds.

11.2 GENERAL RULE

According to the new Art. 212 bis III-1 of the FTC, interest expenses and other costs economically equivalent to interest (for simplicity “interest expenses”), including those capitalized in the cost of the assets\(^3\), are deductible in the tax period in which they are incurred up to the amount of interest revenues and other economically equivalent taxable revenues (for simplicity “interest revenues”) of the year.

Under Art. 212-bis III-1 of the FTC, any excess of interest expenses over interest revenues (for simplicity “net interest expenses”) is deductible up to the highest amount between €3 million and 30% of the EBITDA of the tax period. For a consolidated group, for tax purposes as opposed to accounting purposes, these limits should be assessed at the level of the tax group (See §11.8 below).

The net interest expenses should be, firstly, offset against the 30% EBITDA of the year or €3 million and, subsequently, against the unused capacity for interest deduction which is carried forward, as a matter of principles, during five financial years.

It must be noted that France has decided to fully implement one of the three carry-forward mechanisms provided by the Art. 4, par. 6 of the ATAD Directive.

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\(^{3}\) Art. 212 bis III-2-c of the FTC.
Indeed, on the one hand, according to Art. 212 bis VIII-1 of the FTC, interest expenses not deductible following the French ATAD directive limit rule are not deductible in the relevant tax period and are carried forward to the following fiscal years, without any time limit.

If the company is not deemed thin-capitalized, such exceeding interest expenses may therefore, be deducted in a subsequent fiscal year if the net interest expenses of the year do not exceed the 30% EBITDA of the year (or €3 million). According to the French Tax Authorities (the FTA) guidelines\textsuperscript{205}, a company can deduct the carried forward net interest expenses as long as the thresholds of this year have not been reached.

On the other hand, according to Art. 212 bis VIII-2 of the FTC, if – in a tax period – the 30% EBITDA is higher than the net interest expenses of the year or the previous years, which cannot be used for offsetting the exceeding interest expenses, an interest exceeding EBITDA or unused capacity of five years to offset future exceeding interest can be carried forward for a maximum of five years to offset future exceeding interest expenses. It must however be underlined that this excess of 30% EBITDA or unused capacity cannot be used for offsetting the exceeding interest expenses of the previous years, which is a more restrictive condition retained by France in comparison with the ATAD Directive.

### 11.3 THE DEFINITION OF INTEREST EXPENSES AND REVENUES

Under the new Art. 212 bis III-2 of the FTC, which defines the objective scope of the provision, interest expenses and revenues relevant for the purpose of the rule are those corresponding to interest on all forms of debt, i.e. those relating to sums left or made available to or by the enterprise, including:

- i. payments made under equity loans or bonds;
- ii. amounts disbursed as alternative financing;
- iii. amortization of capitalized interest included in the original cost of an asset and, where applicable, the part of the interest included in the net book value of removed assets;
- iv. amounts measured by reference to a financial performance determined by comparison with similar companies ordinarily operated within the meaning of Article 57 of the FTC;
- v. interest paid under derivatives or loan hedging agreements of the company;
- vi. foreign exchange gains and losses relating to loans, borrowings and instruments related to financings;
- vii. guarantee fees relating to financing operations;
- viii. administrative fees related to the debt;
- ix. the amount of the rentals, less amortization, financial amortization applied by the lessor under Article 39 C I of the FTC and ancillary charges and services invoiced to the lessee in the case of leasing, hire-purchase or hire-purchase of movable assets between affiliated companies under the meaning of Article 39 (12) of the FTC;
- x. all other costs or income equivalent to interest.

The interest expenses and revenues to be retained to determine the net interest expenses of a fiscal year are the expenses incurred and the revenues earned during that fiscal year.

According to the FTA guidelines, this definition is not limited to the funding granted to the company but, more generally, to the amount of any receivable on the company generating the payment of interest, or the amounts economically equivalent to interest. It has a broader meaning than under the former general limitation on net interest expenses (Rabot).

For example, administrative fees and guarantee fees related to financing operations are now considered as interest expenses, which was not previously the case\textsuperscript{206}. As a result, the scope of the new rule is broader than the previous one.

This French definition is globally in line with ATAD Directive’s definition of the “borrowing costs”\textsuperscript{207}.

### 11.4 THE DETERMINATION OF EBITDA

Art. 212 bis II of the FTC also provides for a definition of EBITDA which is in line with the provisions of the ATAD Directive. EBITDA or “Tax EBITDA” is the taxable income subject to corporate income tax, before allocation of any losses carried forward, increased by four items:

- the net interest expenses, as defined above, which means all the interest expenses within the scope of art. 212 bis of the FTC must be included and all the interest revenues must be deducted;
- the tax-deductible depreciations and amortizations, net of taxable reversals, which excludes particularly non-deductible depreciations and amortizations and the irregularly deferred depreciations and amortizations;
- the tax-deductible provisions, net of taxable provision reversals; and
- the capital gains and losses taxed at a reduced rate (15%, 19% or 25%).

For consolidated tax groups, EBITDA is determined in the same way by Art. 223 B bis of the FTC but at the level of the group taxable income. For example, the sum of deductible provisions for depreciation of each entity member of the group must be reintegrated in the overall tax result of the tax group.

Art. 45 of the Finance Bill for 2020 outlines that the taxable income used for the determination of EBITDA is obtained before application of the interest limitation rules aforementioned. For the tax group, this Article states that only amortizations, depreciations, provisions, gains and losses that have not been restated from the overall result, are used to determine EBITDA.

Although the French definition of EBITDA is quite similar to the definition proposed by the Directive, a certain number of questions remain.

First of all, French law provides that EBITDA is determined on the basis of the result subject to corporate income tax, before imputation of losses. However, in the context of a tax consolidated group, if it is certain that the overall group result to be taken into account is determined before deduction of the group’s losses carried forward, it is less clear when it comes to losses allocated on an extended basis, or to pre-consolidated group losses deducted directly from the individual results of the group companies, while logically these losses should not be taken into account in the group’s EBITDA.

In addition, with regard to the reversal of amortization, the article provides for the add-back of the portion of capital gains or losses corresponding to deducted amortization, without distinction between amortization deducted after the entry into force of the text and amortization deducted before which therefore did not inflate EBITDA.

Finally, even if dividends and capital gains benefitting from an exemption are not included in the EBITDA computation, in accordance with the Directive which excludes tax-exempt income, the share of costs and expenses related to such income should remain included in EBITDA\textsuperscript{208}.

\textsuperscript{205} BOI-IS-BASE:35-40:10-10-20190731.

\textsuperscript{206} Information Report to the Finance Bill for 2019.

\textsuperscript{207} BOI-IS-BASE:35-40:10-10-20200513 $50.

\textsuperscript{208} Article 4 Par. 2 of ATAD Directive.
11.5 THE EXCLUSION OF LONG-TERM PUBLIC INFRASTRUCTURE PROJECTS LOANS

In accordance with Art. 4 Par. 4 of ATAD Directive, France has decided to exclude from the scope of the interest limitation rule the exceeding interest expenses of loans used to fund a long-term public infrastructure project (LTPIP) provided that the project operator, the interest expenses, the assets and the revenues are all located in the European Union. Thus, Art. 212 bis III-3 of the FTC provides that are not included in the net interest expenses, the interest expenses owed by a company when they are related to goods acquired or constructed or to the operations carried out by it for:

- a public service delegation contract;
- a public works concession contract;
- a partnership agreement;
- an emphyteutic lease;
- a contract with a matter equivalent to these contracts, concluded with a contracting authority/entity of another Member State of the European Union.

However, an important distinction is made according to the date of conclusion of the contract.

If the contract is signed before December 29, 2012, the interest expenses related to this contract are simply excluded. In other words, contracts that were already excluded under the “Rabot” mechanism remain outside the scope of the new rule.

For contracts signed as of December 29, 2012, the exclusion is subject to the undertaking of a consultation, or to the publication of a notice of invitation to tender or a concession notice, or to the launch of an approval procedure by decree, before the date of promulgation of the Finance Bill for 2019 (i.e. December 28, 2018).

Even if this condition is fulfilled, the exclusion will not be complete as the text only provides that the related interest expenses are deductible up to a limit of 30% EBITDA or €3 million, plus 75% of the amount (safeguard clause). If no award procedure was launched before the promulgation of the Finance Bill for 2019, the interest expenses are fully subject to this new interest limitation rule.

In addition, to benefit from the total or partial exemption the company must exercise an option, which will be irrevocable and valid for a renewable period of ten years (by the parent company for consolidated tax group).

This appears to be the only exception from the Directive chosen by France, even if France has chosen to limit this exclusion to contracts concluded before the entry into force of the new rules. French rules are therefore more restrictive than the Directive which provides a full exemption, without considering the date of LTPIP.

11.6 DEDUCTIBILITY OF INTEREST EXPENSES IN CASE OF GROUP CONSOLIDATION

ADDITIONAL DEDUCTION RULES FOR CONSOLIDATED GROUP

Art. 212 bis VI of the FTC allows, in case of tax consolidation, an additional deduction of 75% of the amount of exceeding interest expenses following the application of the thresholds (30% EBITDA or €3 million). This safeguard clause is conditioned on the fact that the ratio of companies equity over its total assets is equal to or higher (or, by tolerance, lower by up to two percentage points) than the equivalent ratio of its group.

France used a possibility granted by the ATAD Directive (Art. 4 Par. 5). However, once again, the French rule is stricter than the European regime. Indeed, the ATAD Directive allows Member States to grant a full deduction of the exceeding interest expenses when the company is member of a consolidated group and conditions for additional deduction are met.

The accounting definition of the consolidated group

To benefit from the safeguard clause, the company shall be member of a group, in the accounting sense, whose accounts of French and foreign companies are fully consolidated for the preparation of consolidated financial statements within the meaning of Article L. 233-18 of the French Commercial Code (i.e. the group’s members are under the exclusive control of the consolidating company) or within the meaning of the IFRS mentioned in Article L. 233-24 of the same code.

Therefore, on a strict reading of the text, the safeguard clause shall not apply to groups under US GAAP. However, the FTA guidelines provide that US GAAP groups can also benefit from the safeguard clause, if they meet the same conditions. Consolidated accounts prepared in accordance with Chinese accounting standards for business enterprises (ASBE), South Korean IFRS (K-IFRS), Canadian GAAP, and Japanese accounting consolidation standards, all considered as equivalent to IFRS by decision of the European Commission, are also accepted.

Moreover, the consolidated accounts (US GAAP, IFRS, French rules...) shall be validated by a statutory auditor in the context of a legal audit (certification) or a contractual audit mission carried out in compliance with standards equivalent to NEPs. The publication of these accounts (deposit at the clerk’s office of the competent commercial court) is not mandatory. However, in the absence of such publication, the company shall be able to demonstrate that the consolidated accounts on which it intends to rely have been made in accordance with the consolidation rules that would have been applicable in case of publication.
11.7 ADDITIONAL DEDUCTION RULES FOR AUTONOMOUS ENTITIES

France, in its Finance Bill for 2020, has also allowed the autonomous entities to benefit from the safeguard clause.

An autonomous entity is an entity without any establishment outside of France or any associated enterprise, and which is not member of a consolidated group. Such autonomous entity has the possibility to deduct 75% of the amount of their exceeding interest expenses (over 30% EBITDA or €3 million). However, unlike for the additional deduction of the consolidated group entities, the remaining 25% of exceeding interest expenses cannot be carried forward.

The new provision does not specify if this safeguard clause is an option for autonomous entities or mandatory. Indeed, the text says that the excess of interest expenses “are deductible” instead of “are deducted”, which could imply that this is an option.

This subtle difference matters, since some entities might prefer not to use the safeguard clause in order to carry forward all of their exceeding interest expenses rather than deduct an additional 75%, if, for instance, the autonomous entity already knows that its EBITDA will increase the next fiscal year with interest expenses remaining stable.

11.8 DEDUCTIBILITY OF INTEREST IN CASE OF A FRENCH TAX CONSOLIDATED GROUP

Under Art. 223 A of the FTC, French companies may use the tax consolidated regime in order to create a tax consolidated group, which means that only the parent company becomes liable for tax purposes.

For tax consolidated group, the interest limitation rule regime is mainly identical even if the provisions shall be adjusted to the tax group situation and the elements retained for the computation of the deductible expenses are assessed at the group level:

- net financial expenses and EBITDA;
- the general and specific deductibility thresholds in the event of thin capitalization;
- the ratios of the safeguard clause are, on the one hand, the ratio of equity over assets of the tax group and, on the other hand, the ratio of equity over assets of the consolidated group to which the companies of the tax group belong (which includes any French entity not part of the tax group and foreign entities);
- thin capitalization at a group level neutralization of the intra-group transactions.

A company joining a tax group will not be entitled to use the carried forward interest expenses and deduction capacity acquired prior to its entry into the group. Nevertheless, the company will recover them at the exit of the group (the five-year period of its deferred deduction capacity will be suspended during the tax consolidation). Similarly, exceeding carried forward interest expenses and unused deduction capacity will be recovered by the former parent company in case of termination of the tax group.

Based on this possibility, France has decided to introduce a quite restrictive regime for thin capitalized entities. This new regime replaces the previous French regime by implementing a tighter capping mechanism.

According to Art. 212 bis VII-1 of the FTC, a company is considered thin capitalized if the average amount of the sums left or made available by all its related entities (within the meaning of Art. 39, 12 of the FTC) during a fiscal year exceeds, for this fiscal year, one and a half times the amount of equity (assessed at the company’s discretion at the opening or closing of the fiscal year)213.

Art. 212 bis VII-2 of the FTC provides various exceptions by qualifying interest expenses as sums left or made available by unrelated entities for economic or legal reasons214, such as interest from:

- financing operations carried out, under a cash pooling agreement, centralized by one of the entities;
- acquisition of leased assets;
- sums due by credit institutions or financing companies.

Once the thin capitalization of the company is characterized, the French mechanism requires to distinguish between two basis of interest expenses:

- the interest expenses related to external debt, and
- the interest expenses paid to related entities.

In regards to “external debt” basis:

All the interest expenses must be multiplied by the ratio between:

- for the numerator, the sum of the average amount of sums left or made available to the company during the fiscal year by unrelated entities and one and a half times the amount of equity;
- for the denominator, the average amount of all sums left or made available to the entity during the fiscal year.

Then, the company will determine its deduction limit by applying this ratio to the limits of 30% EBITDA or €3 million. All exceeding interest expenses for the fiscal year may be carried forward and deducted for subsequent fiscal years, as stated above.

(€3 million) or (30% EBITDA) x ([loans from unrelated entities + (1,5 x equity)) / (all loans])

In regards to “debt with related entities” basis:

The “debt with related entities” basis is determined by subtraction of the external debt basis from the total amount of interest expenses.

Then, the deduction limit will correspond to 10% of EBITDA or €1 million, multiplied to the ratio between:

- for the numerator, the sums left or made available to the company by directly or indirectly related entities exceeding one and a half times the amount of equity;
- for the denominator, the average amount of all amounts left or made available to the entity during the fiscal year.

The fraction of interest expenses that would not be deductible under this “debt with related entities” basis may still be deducted for subsequent fiscal years, but only up to one third of their amount.

(€1 million) or (10% EBITDA) x ([loans from related entities > (1,5 x equity)) / (all loans))

213 Meaning that only the debt ratio has been taken over from the former thin-capitalization regime and not the interest coverage ratio and the ratio of interest paid by related entities.
214 BOI-13-2020-00013 SBO.
Although this mechanism is complex, it has the merit of reflecting the real situation of the company. As a consequence, a slightly thin capitalized entity will be able to deduct almost 30% of its EBIDTA (or €3 million) whereas a company which is largely thin capitalized, and which operates almost exclusively with group debt will be subject to a limit close to 10% of its EBIDTA (or €1 million).

Pursuant to Art. 212 bis VII-3 of the FTC, a specific safeguard clause of the thin-capitalization regime provides that a company will not fall within the limited thresholds of 10% of EBIDTA (or €1 million) if the company is able to demonstrate that the debt ratio of its consolidated group is equal to or higher (or, by tolerance, lower by up to two percentage points) than its own debt ratio. In such case, the ordinary thresholds (30% EBIDTA or €3 million) and the additional deduction of 75% will be therefore applicable.

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**12 FRENCH IMPLEMENTATION OF THE ATAD ANTI-HYBRID RULES**


Articles 9, 9a and 9b of ATAD introduced anti-hybrid provisions. Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or financial instrument under the laws of two or more tax jurisdictions to achieve double non-taxation. The 2015 final report of Action 2 of the OECD/G20 BEPS project provided recommendations regarding the design of domestic rules that would neutralize the tax effects of hybrid mismatch arrangements.

As regards to hybrid mismatches, the objective of ATAD is to implement the OECD recommendations in the EU Member States in a coordinated way. Under the anti-hybrid rules, in order to avoid double non-taxation derived by hybrid mismatches, Member States 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.

Article 45 of the ATAD Implementing Law introduced in France hybrid mismatch rules in line with ATAD and the conclusions of Action 2 of the OECD/G20 BEPS project (French Anti-Hybrid Rules). Such provisions will apply from 1 January 2020 except for the reverse hybrid mismatches rule which will be applicable from 1 January 2022.

The explanatory report of ATAD Implementing Law makes explicit reference to recital 28 of ATAD II, which states that explanations and examples in the 2015 OECD BEPS report on Action 2 (BEPS Action 2 Report) can be utilized as a source of interpretation to the extent that they are consistent with the provisions of the Directive, highlighting that the mentioned OECD report has a primary role also in the interpretation of the French Anti-Hybrid Rules.

This section analyses the French Anti-Hybrid Rules illustrating the scope (paragraph 12.1), the rules (paragraph 12.2), the exclusions (paragraph 12.3), the hybrid mismatches covered (paragraph 12.4), the impact on investment funds (paragraph 12.5) and providing for some conclusions (paragraph 12.6).

**12.1 SCOPE OF THE FRENCH ANTI-HYBRID RULES**

The French Anti-Hybrid Rules introduced by ATAD Implementing Law apply to the extent that their subjective, objective and territorial requirements are met.

**SUBJECTIVE SCOPE**

The ATAD Implementing Law provides that anti-hybrid rules apply to taxpayers subject to corporate income tax in France on their business income (French Taxpayer). In particular, they apply to:

- resident companies;
- resident entities carrying out business activities;
- permanent establishments located in France of non-resident companies or entities.

As such, the scope of the French Anti-Hybrid rules is identical to the one of ATAD.
Article 205 B (I)(2) of the FTC, in line with ATAD, limits the subjective scope of the French Anti-Hybrid Rules only to hybrid mismatches that arise between a Taxpayer and an associated enterprise, between associated enterprises, between the head office and an establishment, between two or more establishments of the same entity or under a structured arrangement.

The definition of associated enterprise is provided by article 205 B (I)(16) of the FTC, which includes:

- an entity in which the French Taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 50% or more or is entitled to receive 50% or more of the profits of that entity;
- a person which holds directly or indirectly a participation in terms of voting rights or capital ownership in a French Taxpayer of 50% or more or is entitled to receive 50% or more of the profits of the French Taxpayer;
- an entity in which a person, who holds, directly or indirectly, a participation in terms of voting rights or capital ownership of at least 50%, holds a participation in terms of voting rights or capital ownership of at least 50% of the voting rights or capital;
- an entity which is a member of the same consolidated group of the French Taxpayer within the meaning of Article 212 bis (IV)(2) of the FTC;
- an enterprise which has a dominant influence in the management216;
- an enterprise which has a dominant influence in the management of the French Taxpayer217.

In case of hybrid financial instrument or a deemed payment made by an establishment to its head office, the 50% threshold indicated above is reduced to 25%, pursuant to article 205 B (I)(16) of the FTC. The lowering of the threshold is also provided for in ATAD as amended by ATAD 2 but in an inverted form: Article 2(4) of ATAD provided for a minimum holding of 25% increased to 50% in some cases.

For the purpose of the associated enterprise definition, voting rights or capital ownership of persons acting together shall be aggregated. Indeed, in line with ATAD, article 205 B (16)(d) provides that 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. The “acting together” concept is defined neither by the ATAD Implementing Law nor by the explanatory reports of the law218.

A structured arrangement is defined in article 205B(I)(14) as an arrangement “of which terms include the valuation of the asymmetry effect or an arrangement that was designed to generate the same consequences as a hybrid device, where the Taxpayer cannot demonstrate that he or an associated enterprise was not aware of the hybrid arrangement and did not benefit from the resulting tax advantage”. While both ATAD and the FTC cover structured arrangement whose terms incorporate the valuation derived from tax asymmetry or which have been designed to generate asymmetry, the FTC places the burden of proof on the Taxpayer while ATAD seems more nuanced since it can be interpreted as requiring the Administration to prove that the Taxpayer was informed and received the benefit.

OBJECTIVE SCOPE

ATAD Implementing Law addresses the following categories of hybrid mismatches:

- hybrid financial instrument, pursuant to article 205 B (I)(1)(a) and (8) of the FTC;
- payment to a hybrid entity established in another Country, pursuant to article 205 B(I)(1)(b) of the FTC;
- payment to an entity with one or more establishments, pursuant to article 205 B (I)(1)(c) of the FTC;
- payment to a disregarded establishment, pursuant to article 205 B (I)(1)(d) of the FTC;
- payment by a hybrid entity, pursuant to article 205 B(I)(1)(e) of the FTC;
- deemed payment between an establishment and the head office or between establishments, pursuant to article 205 B (I)(1)(f) of the FTC;
- double deduction outcome, pursuant to article 205 B(I)(1)(g) of the FTC;
- hybrid transfer, pursuant to article 205 B(III) (5) (of the FTC;
- imported hybrid mismatches, pursuant to article 205 B (III)(3) of the FTC;
- reverse hybrid mismatches, pursuant to article 205 B (I)(15) and article 205 C of the FTC;
- dual residency mismatches, pursuant to article 205 D of the FTC.

ATAD Implementing Law targets only hybrid mismatches that lead to one of the four following outcomes:

- payments that give rise to a deduction / non-inclusion outcome (D/NI outcome), meaning payments that are deductible under the rules of the payer’s Country of residence and are not included in the ordinary income of the payee. Adding to ATAD, the ATAD Implementing Law specifies that the payer is a person who is required to make a payment, the payment being any right to a transfer of value associated with an amount liable to be paid219. The Country of residence is the place where a person is considered to have their registered office or place of residence for tax purposes;
- payments that give rise to a double deduction outcome (DD outcome), meaning payments that give rise to two deductions in respect of the same payment, one in the Country of the payer and the other in the Country of the investor;
- payments that give rise to an indirect deduction / non-inclusion (indirect D/NI outcome), meaning payments that are deductible in the hands of the French Taxpayer making the payments and that are set-off by the payee against a deduction under a hybrid mismatch arrangement;
- the production of a tax relief for withholding tax for a payment from a financial instrument transferred to more than one of the parties involved in the transfer.

TERRITORIAL SCOPE

French Anti-Hybrid Rules cover cross-border hybrid mismatches where one of the parties involved is a French Taxpayer.
12.2 FRENCH ANTI-HYBRID RULES

In line with ATAD II, article 205 B(III) of the FTC provides for two general rules to counteract double deduction outcome and deduction non-inclusion outcome respectively.

According to article 205 B(III)(2) of the FTC, if a hybrid mismatch results in a double deduction, as a primary rule, the deduction shall be denied in France if it is the investor Country of residence. As a defensive rule, where the deduction is not denied in the investor Country of residence, the deduction shall be denied in France if it is the payer Country of residence.

According to article 205 B(III) of the FTC, if a hybrid mismatch results in a deduction without inclusion, as a primary rule, the deduction shall be denied in France if it is the payer Country of residence. As a defensive rule, where the deduction is not denied in the payer Country of residence, the payment (more precisely, the amount of the payment that would otherwise give rise to a mismatch outcome) shall be included in the income in France if it is the investor Country of residence.

In addition, article 205 B(III)(3) of the FTC provides for specific anti-hybrid rules to counteract imported hybrid mismatches, the case of a head office in France and a disregarded establishment, hybrid transfer, reverse hybrid mismatches and dual residency mismatches.

12.3 EXCLUSION FROM FRENCH ANTI-HYBRID RULES

Article 205 B(III)(1) of the FTC expressly excludes from the scope of application of these anti-hybrid measures the payment carried out by any financial trader, i.e. any person whose professional activity consists in buying or selling, on a regular basis and for profit, financial instruments for his own account.

In order to benefit from this exception, the financial trader must, however, demonstrates that the transaction in question is indeed carried out in the context of his usual activities, that it does not constitute a structured arrangement and that the income received in this context is effectively included in his taxable income.

This exclusion is in line with article 2 (9) of ATAD.

12.4 ROLE OF FRANCE IN APPLYING FRENCH ANTI-HYBRID RULES

In order to neutralise the effects of hybrid mismatches, anti-hybrid rules require a response from either the payer jurisdiction or the payee jurisdiction or the investor jurisdiction, as the case may be.

France qualifies:

• as the payer jurisdiction, if the payment is deductible in the hands of a French Taxpayer;
• as the investor jurisdiction, if the payment made by a non-resident (or by a foreign permanent establishment of an Italian Taxpayer) is attributed to a French Taxpayer and it is deductible in its hands;

12.5 HYBRID MISMATCHES COVERED BY FRENCH ANTI-HYBRID RULES

As indicated above, ATAD Implementing Law addresses several categories of hybrid mismatches, which will be analysed on the next page.

HYBRID FINANCIAL INSTRUMENT

According to article 205B (I)(a) of the FTC, a hybrid mismatch arrangement occurs in relation to a payment under a financial instrument or a hybrid transfer if the following conditions are met:

• the payment is made in respect of a financial instrument;
• the payment gives rise to a charge deductible in the Country of residence of the payer without being included in the taxable income in the Country of residence of the payee;
• the mismatch outcome is attributable to the different characterisation of the financial instrument (or the payment made under it) in the payer and payee countries.

Article 205 B (I)(B) of the FTC provides that a payment is in principle considered to be included when it is taken into account in the taxable income of the payee under the rules of its Country of residence. However, a more flexible understanding of inclusion applies to financial instruments, by which a payment is considered to be included when the following two criteria are met:

i. if, by reason of the nature of the payment, it has not given rise, under the rules of the Country of residence of that payee to an exemption, a reduction in the rate of tax or a credit or refund of tax, other than a tax credit in respect of a withholding tax;

ii. if such inclusion is in respect of a financial year that begins within 24 months after the end of the financial year in respect of which the expense was deducted (The “Twenty-Four Month Period). This rule thus differs from the tolerance provided for in ATAD 2, according to which a payment made in respect of a financial instrument is included within a reasonable time when (a) such inclusion occurs in a tax period that begins within 12 months of the end of the payer’s tax period, or (b) it is reasonable to expect that the payment will be included by the Country of residence of the beneficiary in a subsequent tax period and that the terms of payment are those which could be reasonably expected to be agreed between independent enterprises. By setting a fixed Twenty-Four Month Period, the FTC does not allow the flexibility opened by ATAD. The practicalities of the later deduction would have to be clarified by the French Tax Administration.

RULES

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 205 B (III)(I) of the FTC:

• if France is the payer jurisdiction, it denies the deduction of the payment in the hands of the payer (pursuant to the OECD principles, the amount should be limited to the amount of the payment that would otherwise give rise to a mismatch outcome), unless the mismatch is neutralized in another Country. In order to avoid double taxation, if France denies the deduction under this rule and the payee jurisdiction includes the payment in the ordinary income of the payee before the Twenty-Four Month Period, France will allow the deduction (previously denied) in the hands of the payer;

• if France is the payee jurisdiction, it includes the payment (pursuant to the OECD principles, the amount should be limited to the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country.

220 A financial instrument is defined in article 205 B(III)(2) of the FTC as “an instrument that generates a financial return that is subject, either in the Country of residence of the payer or in the Country of residence of the payee, to the tax rules applicable to debt securities, equity securities or derivative instruments, including any hybrid transfer”. As such, the perimeter of the instruments targeted seems to be broad: for example, payments may be made in connection with the holding of ordinary shares, preference shares, bonds of all types, units in collective investment schemes, but also in connection with forward financial instruments or derivatives.

221 The parent/subsidiary regime could be an example of an exemption linked to the nature of the payment. Please note that an exemption because of the tax regime of the entity would not meet this criterion.

222 An establishment is defined as an enterprise carried on in France within the meaning of Article 209 (I) of the FTC or an establishment within the meaning of the legislation applicable in the Country in which it is located or in the Country of the head office of the entity on which it depends, or a permanent establishment within the meaning of international conventions relating to double taxation.
The interest payment described in the example falls within the scope of the hybrid financial instrument rule.

If France is Country B, it denies B Co the deduction for the interest paid to A Co, unless the mismatch is neutralized in another Country. In order to avoid double taxation, if France denies B Co the deduction and Country A includes the payment in the ordinary income of A Co before the Twenty-Four-Month Period, France will allow B Co the deduction (previously denied). If France is Country A, it includes the payment in the ordinary income of A Co, unless the deduction is denied in Country B or the mismatch is neutralized in another Country.

**PAYMENT TO A HYBRID ENTITY**

Article 205 B (1)(1) of the FTC defines “hybrid entity” as any entity or arrangement which is treated as an entity liable to tax by a Country (i.e. opaque entity) and the income or expenses of which are treated as income or expenses of one or more persons by another Country (i.e. a transparent entity).

According to article 205 B (1)(1)(b), a hybrid mismatch arrangement occurs in relation to a payment to a hybrid entity if the following conditions are met:

- a hybrid entity benefits from a payment and is located in a Country in which it is seen as a transparent entity;
- a deduction without inclusion between the Taxpayer and an associate enterprise or between associated enterprises of the same Taxpayer. Article 205 B (1)(8) of the FTC provides that a payment is in principle considered to be included when it is taken into account in the taxable income of the payee under the rules of its Country of residence;
- one or more shareholders are located in another Country which allocates the payments to the hybrid entity as a taxable person.

**RULES**

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 205 B (III)(1) of the FTC:

- if France is the payer jurisdiction, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country. As opposed to the rules applicable to hybrid financial instruments, there is no precision as to the delay in which the inclusion must take place;
- if France is the payee jurisdiction, it includes the payment (pursuant to the OECD principles, the amount should be limited to the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country.

**PAYMENT TO AN ENTITY WITH ONE OR MORE ESTABLISHMENTS**

According to article 205 B (1)(1)(c) of the FTC, a hybrid mismatch arrangement occurs in relation to a payment to an entity with one or more establishments if the following conditions are met:

- a payment is made to an establishment located in a Country which treats the payment as attributable to the seat of the establishment or to an establishment of the same entity;
- a mismatch outcome in the form of a deduction without inclusion between the Taxpayer and an associate enterprise, between associate enterprises of the same Taxpayer, between the head office and the establishment or between two or more establishments of the same entity;
- a head office or an establishment of the same entity located in another Country in which the payment is attributed to the establishment.

**EXCEPTIONS**

Article 205 B (1)(1) of the FTC expressly excludes from the scope of application of these anti-hybrid measures the operations carried out by any financial trader, i.e. any person whose professional activity consists in buying or selling, on a regular basis and for profit, financial instruments for his own account. In order to benefit from this exception, the financial trader must, however, demonstrate that the transaction in question is instead carried out in the context of his usual activities, that it does not constitute a structured arrangement and that the income received in this context is effectively included in his taxable income.

This exclusion is in line with article 2 (9) of ATAD which provides for such exclusion.

**EXAMPLE**

Here below an example of a hybrid mismatch deriving from a hybrid financial instrument which is line with Example 1.1 of BEPS Action 2 Report and it is also mentioned by the explanatory report of ATAD Implementing Law.

A Co (a company resident in Country A) owns all the shares in B Co (a company resident in Country B). A Co lends money to B Co. The loan is treated as a debt instrument under the laws of Country B but as an equity instrument (i.e. a share) under the laws of Country A. Interest payments on the loan are treated as a deductible expense under Country B law but as exempt dividends under Country A law.

The interest payment described in the example falls within the scope of the hybrid financial instrument rule.

If France is Country B, it denies B Co the deduction for the interest paid to A Co, unless the mismatch is neutralized in another Country. In order to avoid double taxation, if France denies B Co the deduction and Country A includes the payment in the ordinary income of A Co before the Twenty-Four-Month Period, France will allow B Co the deduction (previously denied). If France is Country A, it includes the payment in the ordinary income of A Co, unless the deduction is denied in Country B or the mismatch is neutralized in another Country.

**PAYMENT TO A HYBRID ENTITY**

Article 205 B (1)(1) of the FTC defines “hybrid entity” as any entity or arrangement which is treated as an entity liable to tax by a Country (i.e. opaque entity) and the income or expenses of which are treated as income or expenses of one or more persons by another Country (i.e. a transparent entity).

According to article 205 B (1)(1)(b), a hybrid mismatch arrangement occurs in relation to a payment to a hybrid entity if the following conditions are met:

- a hybrid entity benefits from a payment and is located in a Country in which it is seen as a transparent entity;
- a deduction without inclusion between the Taxpayer and an associate enterprise or between associated enterprises of the same entity located in another Country. As opposed to the rules applicable to hybrid financial instruments, there is no precision as to the delay in which the inclusion must take place;
- one or more shareholders are located in another Country which allocates the payments to the hybrid entity as a taxable person.

**RULES**

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 205 B (III)(1) of the FTC:

- if France is the payer jurisdiction, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country. As opposed to the rules applicable to hybrid financial instruments, there is no precision as to the delay in which the inclusion must take place;
- if France is the payee jurisdiction, it includes the payment (pursuant to the OECD principles, the amount should be limited to the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country.

**PAYMENT TO AN ENTITY WITH ONE OR MORE ESTABLISHMENTS**

According to article 205 B (1)(1)(c) of the FTC, a hybrid mismatch arrangement occurs in relation to a payment to an entity with one or more establishments if the following conditions are met:

- a payment is made to an establishment located in a Country which treats the payment as attributable to the seat of the establishment or to an establishment of the same entity;
- a mismatch outcome in the form of a deduction without inclusion between the Taxpayer and an associate enterprise, between associate enterprises of the same Taxpayer, between the head office and the establishment or between two or more establishments of the same entity;
- a head office or an establishment of the same entity located in another Country in which the payment is attributed to the establishment.

**EXCEPTIONS**

Article 205 B (1)(1) of the FTC expressly excludes from the scope of application of these anti-hybrid measures the operations carried out by any financial trader, i.e. any person whose professional activity consists in buying or selling, on a regular basis and for profit, financial instruments for his own account. In order to benefit from this exception, the financial trader must, however, demonstrate that the transaction in question is indeed carried out in the context of his usual activities, that it does not constitute a structured arrangement and that the income received in this context is effectively included in his taxable income.

This exclusion is in line with article 2 (9) of ATAD which provides for such exclusion.

**EXAMPLE**

Here below an example of a hybrid mismatch deriving from a hybrid financial instrument which is line with Example 1.1 of BEPS Action 2 Report and it is also mentioned by the explanatory report of ATAD Implementing Law.

A Co (a company resident in Country A) owns all the shares in B Co (a company resident in Country B). A Co lends money to B Co. The loan is treated as a debt instrument under the laws of Country B but as an equity instrument (i.e. a share) under the laws of Country A. Interest payments on the loan are treated as a deductible expense under Country B law but as exempt dividends under Country A law.

The interest payment described in the example falls within the scope of the hybrid financial instrument rule.

If France is Country B, it denies B Co the deduction for the interest paid to A Co, unless the mismatch is neutralized in another Country. In order to avoid double taxation, if France denies B Co the deduction and Country A includes the payment in the ordinary income of A Co before the Twenty-Four-Month Period, France will allow B Co the deduction (previously denied). If France is Country A, it includes the payment in the ordinary income of A Co, unless the deduction is denied in Country B or the mismatch is neutralized in another Country.

**PAYMENT TO A HYBRID ENTITY**

Article 205 B (1)(1) of the FTC defines “hybrid entity” as any entity or arrangement which is treated as an entity liable to tax by a Country (i.e. opaque entity) and the income or expenses of which are treated as income or expenses of one or more persons by another Country (i.e. a transparent entity).

According to article 205 B (1)(1)(b), a hybrid mismatch arrangement occurs in relation to a payment to a hybrid entity if the following conditions are met:

- a hybrid entity benefits from a payment and is located in a Country in which it is seen as a transparent entity;
- a deduction without inclusion between the Taxpayer and an associate enterprise or between associated enterprises of the same entity located in another Country. As opposed to the rules applicable to hybrid financial instruments, there is no precision as to the delay in which the inclusion must take place;
- one or more shareholders are located in another Country which allocates the payments to the hybrid entity as a taxable person.

**RULES**

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 205 B (III)(1) of the FTC:

- if France is the payer jurisdiction, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country. As opposed to the rules applicable to hybrid financial instruments, there is no precision as to the delay in which the inclusion must take place;
- if France is the payee jurisdiction, it includes the payment (pursuant to the OECD principles, the amount should be limited to the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country.

**PAYMENT TO AN ENTITY WITH ONE OR MORE ESTABLISHMENTS**

According to article 205 B (1)(1)(c) of the FTC, a hybrid mismatch arrangement occurs in relation to a payment to an entity with one or more establishments if the following conditions are met:

- a payment is made to an establishment located in a Country which treats the payment as attributable to the seat of the establishment or to an establishment of the same entity;
- a mismatch outcome in the form of a deduction without inclusion between the Taxpayer and an associate enterprise, between associate enterprises of the same Taxpayer, between the head office and the establishment or between two or more establishments of the same entity;
- a head office or an establishment of the same entity located in another Country in which the payment is attributed to the establishment.
RULES

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 205 B (III)(1) of the FTC:

• if France is the payer jurisdiction, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country. As opposed to the rules applicable to hybrid financial instruments, there is no precision as to the delay in which the inclusion must take place.

• if France is the head office jurisdiction, it includes the payment (pursuant to the OECD principles, the amount should be limited to the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the head office, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country;

• if France is the establishment jurisdiction, it includes the payment (pursuant to the OECD principles, the amount should be limited to the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the establishment, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country.

EXAMPLE

The next example is of a hybrid mismatch deriving from a payment to an entity with an establishment illustrated under paragraph 8 of the 2017 OECD BEPS report on Action 2 regarding branch mismatches.

A Co establishes an establishment in Country B (B Branch) and a subsidiary in Country C (C Co). B Branch lends money to C Co.

Under the law of Country B, interest payments on the loan are allocated to B Branch to which a domestic branch exemption regime applies, therefore they are not included in the ordinary income of A Co.

In addition, under the law of Country A, interest payments on the loan are allocated to B Branch to which a domestic branch exemption regime applies, therefore they are not included in the ordinary income of A Co.

A hybrid entity if the following conditions are met:

• an establishment is the beneficiary of a payment and is located in a Country who does not recognize the existence of the said establishment224;

• a mismatch outcome in the form of a deduction without inclusion between the Taxpayer and an associate enterprise, between associate enterprises of the same Taxpayer, between the head office and the establishment or between two or more establishments of the same entity;

• a head office or an establishment of the same entity located in another Country which does recognize the existence of the said establishment.

RULES

According to the ATAD Implementing Law:

• if France is the head office jurisdiction, according to article 205 B (III)(5) of the FTC, it includes the payment in the ordinary income of the head office, unless the tax treaty between France and the other Country imposes the exemption of the profits of the establishment. According to recital 29 of ATAD II, this rule has a priority over the general anti-hybrid rules provided by article 9(1) and 9(2), which corresponds to article 205 B (III)(1) of the FTC.

• if France is the payer jurisdiction, according to article 205 B (I)(I)(d) of the FTC, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country. As opposed to the rules applicable to hybrid financial instruments, there is no precision as to the delay in which the inclusion must take place.

EXAMPLE

The next example is of a hybrid mismatch deriving from a payment to a disregarded establishment.

A Co establishes an establishment in Country B (B Branch) and a subsidiary in Country C (C Co). B Branch lends money to C Co.

Under the law of Country A, interest payments on the loan are allocated to B Branch to which a domestic branch exemption regime applies, therefore they are not included in the ordinary income of A Co. Under the law of Country B, the existence of an establishment is not recognized and therefore interest payments on the loan are not taxed in Country B.

According to article 205 B (I)(I)(a) of the FTC, a hybrid mismatch arrangement occurs in relation to a disregarded payment made by

224 For the definition of establishment, please refer to the previous section regarding payment to an entity with one or more establishments.
**Disregarded Payment Made by a Hybrid Entity**

According to article 205 B (1)(I)(e) of the FTC, a hybrid mismatch arrangement occurs in relation to a disregarded payment made by a hybrid entity if the following conditions are met:

- a hybrid entity makes a payment. Such entity is situated in a Country which treats it as a taxable person. Thus, the entity is entitled to deduct that payment;
- a mismatch outcome in the form of a deduction without inclusion between the Taxpayer and an associate enterprise, between associate enterprises of the same Taxpayer;
- a shareholder who benefit from the payment is located in a Country which treats the hybrid entity as a non-taxable person.

**Rules**

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 205 B (III)(1) of the FTC:

- if France is the payer jurisdiction, it denies the deduction of the payment in the hands of the payer, unless the mismatch is neutralized in another Country. As opposed to the rules applicable to hybrid financial instruments, there is no precision as to the delay in which the inclusion must take place. While ATAD 2 provided that the payer jurisdiction should allow the deduction to be set off against an amount that is dual inclusion income, the FTC does not provide for such case;
- if France is the payee jurisdiction, it includes the payment (pursuant to the OECD principles, the amount should be limited to the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payee, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country.

**Example**

Here below an example of a hybrid mismatch deriving from a disregarded payment made by a hybrid entity.

B Co is a hybrid entity that is fully owned by A Co (a company resident in Country A). B Co is treated as a separate taxable entity under Country B law, it has no income and it is consolidated with B Sub 1, under Country B’s tax grouping regime.

A Co lends money to B Co. Country A considers B Co as a transparent entity and does not recognise the payments from B Co to A Co.

The interest payment described in the example falls within the scope of the rule related to disregarded payments made by a hybrid entity.

If France is Country B, it denies B Co the deduction for the interest paid to A Co, unless the mismatch is neutralized in another Country.

If France is Country A, it includes the payment in the ordinary income of A Co, unless the deduction is denied in Country B or the mismatch is neutralized in another Country.

**Deemed Payment Between the Head Office and an Establishment or Between Two or More Establishments**

According to article 205 B (1)(I)(f) of the FTC, a hybrid mismatch arrangement occurs in relation to a payment between the head office and an establishment or between two or more establishments if the following conditions are met:

- an establishment makes a deemed payment. That establishment is situated in a Country which permits the deduction of that payment. According to the OECD, this type of payment should be deemed to be made solely for tax purposes and should not involve the creation of economic rights between the parties. This notion is illustrated in particular by notional royalties paid by an establishment to its head office. In France, the notion of notional royalties is not retained by the FTC;
- a mismatch outcome in the form of a deduction without inclusion between the head office and the establishment and between two or more establishments of the same entity;
- a head office or an establishment of the same entity which benefits from the deemed payment and is located in a Country which does not take into account deemed payments.

**Rules**

Since the hybrid mismatch gives rise to a deduction without inclusion outcome, according to article 205 B (III)(1) of the FTC:

- if France is the payer jurisdiction, it includes the payment (pursuant to the OECD principles, the amount should be limited to the amount of the payment that would otherwise give rise to a mismatch outcome) in the ordinary income of the payer, unless the deduction is denied in the payer jurisdiction or the mismatch is neutralized in another Country.

**Example**

Here below an example of a hybrid mismatch arising from payments between the head office and an establishment, which is illustrated under paragraph 11 of the 2017 OECD BEPS report on Action 2 regarding branch mismatches.

A Co supplies services to an unrelated company (C Co) through a branch located in Country B. The services supplied by the branch exploit underlying intangibles owned by A Co. Country B attributes the ownership of those intangibles to the head office and treats the branch as making a corresponding arm’s length payment to compensate A Co for the use of those intangibles. This deemed payment is deductible under Country B law but is not recognised under Country A law (because Country A attributes the ownership of the intangibles to the branch). Meanwhile, the services income received by B branch is exempt from taxation under Country A law due to a domestic branch exemption regime.
The deemed royalty payment described in the example falls within the scope of the anti-hybrid rule regarding payments between the head office and an establishment.

If France is Country B, it denies B Branch the deduction for the notional royalty payment, unless the mismatch is neutralized in another Country.

If France is Country A, it includes the payment in the ordinary income of A Co, unless the deduction is denied in Country B or the mismatch is neutralized in another Country.

DOUBLE DEDUCTION OUTCOME

According to article 205 B (I)(1)(g) of the FTC, a hybrid mismatch arises if the following conditions are met:

• a payer makes a payment;

• a mismatch outcome in the form of a double deduction occurs between the Taxpayer and an associated enterprise or between associated enterprises of the same Taxpayer or between the head office and the establishment or between two or more establishments of the same entity. It is not necessary that the beneficiary and the payer are associated enterprises;

• an investor, a head office or an establishment of the same entity is located in a Country which allows the deduction of the payment.

RULES

Since the hybrid mismatch gives rise to a double deduction outcome, according to article 205 B (III)(2) of the FTC:

• if France is the investor jurisdiction, it denies the deduction in the hands of the payer, unless the deduction is denied in the investor jurisdiction.

However the rule is not applicable if the income subject to the double deduction is also subject to a double inclusion\(^2\) as of the same financial year or as of a financial year which commences within 24 months of the end of the financial year in respect of which the expense was originally deducted.

EXEMPLARY

Here below an example of a hybrid mismatch leading to a double deduction outcome.

A Co establishes B Co 1 as the holding company for its operating subsidiary (B Co 2). B Co 1 is a hybrid entity (i.e. an entity that is treated as a separate entity for tax purposes in Country B but as a disregarded entity under Country A law).

B Co 1 borrows money from a local bank. The interest on the loan is treated as a deductible expense under both Country A and B laws. B Co 1 and B Co 2 are members of the same tax group under Country B law so that any net loss of B Co 1 can be surrendered under the grouping regime to be set-off against the income of B Co 2.

The interest payment described in the example falls within the scope of the rule regarding double deduction mismatches:

• if France is the payer jurisdiction, it denies the deduction of the payment in the hands of A Co;

• if France is Country A, it denies the deduction in the hands of the B Co 1, unless the deduction is denied in Country A.

HYBRID TRANSFER

According to article 205 B (I)(1)(13) of the FTC, a hybrid transfer is an arrangement allowing the transfer of a financial instrument where the underlying return on the transferred financial instrument is considered for tax purposes to have been obtained simultaneously by more than one of the parties to that device.

RULE

Pursuant article 205 B (III)(5) of the FTC, where a hybrid transfer is designed to give rise to withholding tax relief in respect of a payment from a financial instrument transferred to more than one of the parties involved in the transfer, the benefit of such relief shall be limited in proportion to the net taxable income related to that payment.

EXAMPLE

The next example is of an imported hybrid mismatch.

C Co (a company resident in Country C) has subscribed to bonds issued by A Co (a company resident in Country A). A Co loans the bonds to B Co (a company resident in Country B). B Co transfers, net of withholding tax, the interest received from those bonds.

The deemed return on the transferred financial instrument thereby undermines the effectiveness of the rules that neutralize hybrid mismatches. A deductible payment in a Member State can be used to fund expenditure involving a hybrid mismatch”.

According to article 205 B (III)(3) of the FTC, an imported hybrid mismatch arises if a deductible payment in France funds an expenditure which is deducted in another Country and gives rise to a hybrid mismatch. In particular, an imported hybrid mismatch occurs if the following conditions are met:

• a transaction or series of transaction between associated enterprises of the same Taxpayer or;
The interest payment from C Co to B Co falls within the scope of the rule regarding double deduction mismatches because:

- the deductible interest payment in the hands of C Co directly funds a deductible expenditure (i.e. the interest payment deducted by B Co) giving rise to a hybrid mismatch;
- such hybrid mismatch is achieved through a series of transactions between associated enterprises.

If France is Country C, it denies the deduction of the interest payment in the hands of C Co, unless Country A or Country B have made an adjustment in respect of such hybrid mismatch.

REVERSE HYBRID MISMATCHES

A reverse hybrid entity is an entity or arrangement that for income tax purposes is regarded as an opaque entity (i.e. a taxable entity) under the laws of the investor Country and as a transparent entity (i.e. an entity whose income or expenditure is treated as income or expenditure of one or more other persons) under the laws of its establishment.

In line with article 9a of ATAD II, article 205 C of the FTC provides for a specific anti-hybrid rule neutralizing reverse hybrid mismatches. According to this provision, if certain conditions are met, the reverse hybrid entity established in France shall not be considered as transparent but as a taxable entity in relation to the income not taxed in another Country.

According to recital 29 of ATAD II, this rule has a priority over the general anti-hybrid rules provided by articles 9(1) and 9(2) of ATAD II which are aimed to counteract double deduction and deduction non-inclusion outcomes respectively. In addition, it has to be noted that this specific anti-hybrid rule will apply from 1 January 2022.

EXCEPTION

Pursuant article 205 C of the FTC, the reverse hybrid mismatch rule is not applicable to "collective investment vehicles defined as 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". The "widely held" notion would need to be defined in the FTA guidelines.

The interest payment described in the example does not fall within the scope of the reverse hybrid mismatch rule because under the current French income tax system, interest payments received by C Co are taxed in France in the hands of A Co. However, if B Co were to be a transparent entity, meaning that the interests payments are not taxed in France, the reverse hybrid mismatch rule would trigger and the payments would be taxable in France.
DUAL RESIDENCY MISMATCHES

The dual residency mismatches rule covers cases where a French Taxpayer is resident in France and also in another jurisdiction. A double deduction outcome could arise in this case.

In line with article 9b of ATAD II, article 205 D of the FTC provides for a specific anti-hybrid rule neutralizing dual residency mismatches when the following conditions are met:

- the French Taxpayer is resident in France and also: (i) in another non-EU jurisdiction or (ii) in another Member State but it is deemed to be a resident of the other Member State according to the double taxation treaty between France and the other Member State;
- a double deduction outcome occurs (i.e. a payment is deductible under the laws of both France and the other jurisdictions).

Rule

If a dual residency mismatch occurs, France 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;
- the mismatch is not neutralized in another Country.

EXAMPLE

Here below an example of a dual residency mismatch.

A Co owns all of the shares in AB Co which is resident for tax purposes in both Country A and Country B. A Co is consolidated with AB Co under Country A law.

AB Co owns all the shares in B Co, resident in Country B. AB Co is consolidated with B Co under Country B law. AB Co does not have any taxable income.

Interest payment from AB Co to the Bank are deducted both in Country A against the taxable income of A Co and in Country B against the taxable income of B Co. In both cases the deduction is not set off against dual inclusion income.

The interest payment from AB Co to the Bank falls within the scope of the rule regarding dual residency mismatches.

If France is Country A and Country B is not an EU Member State, France shall deny the deduction to the extent that Country B allows the duplicate deduction.

If France is Country A and Country B is an EU Member State, if AB Co is deemed to be a resident of Country B according to the double taxation treaty between France and Country B, France shall deny the deduction to the extent that Country B allows the duplicate deduction.

12.6 IMPACT OF FRENCH ANTI-HYBRID RULES ON INVESTMENT FUNDS

Investment funds could in theory have been impacted by anti-hybrid rules and in particular by the reverse hybrid entities mismatch mechanism. However, article 205 C of the FTC provides that such rules are not applicable to collective investment vehicles. However, the scope of this exemption would have to be precised by the FTA guidelines as are targeted by this exemption “widely held funds” which are not yet defined in French tax law.

Investment funds could however be impacted by the rule applicable to payment to a hybrid entity. Indeed, if the fund were to be seen as opaque by one of its investors, the deduction of the payment made to that fund could be denied in France if the investor is an associate enterprise of the payer or in case of a structured arrangement.

12.7 CONCLUSIONS

Articles 44 of ATAD Implementing Law introduced in France hybrid mismatch rules in line with ATAD and the conclusions of Action 2 of the OECD/G20 BEPS project. Such provisions will apply from 1 January 2020 except for the reverse hybrid mismatches rule which will be applicable from 1 January 2022. The scope of the French Anti-Hybrid Rules is line with the one of ATAD.

Other than for the rule regarding hybrid financial instrument, which provides for a fixed 24 Month delay, there is no precision regarding the timing in which the inclusion must take place leading to some uncertainties as to the practical aspect of the application of those rules.

As indicated in the explanatory report of ATAD Implementing Law, under the current French income tax system, the reverse hybrid mismatch rule should rarely apply in France. Indeed, income related to transparent entities established in France is attributed to the non-resident investors and taxed in France in their hands.

Thanks to the exclusion of collective investment vehicles from the reverse hybrid entities mismatch mechanism, investment fund should not be much impacted by the French anti hybrid rules even if the scope of this exemption will have to be precised by the French tax administration guidelines.
13 DUTCH IMPLEMENTATION OF THE ATAD INTEREST LIMITATION RULE

13.1 INTRODUCTION

The Netherlands has implemented the earningsstripping rule in 2019. The Dutch earningsstripping rule is regulated in article 15b, 15ba, 15bb and 15bc Dutch Corporate Income Tax Act 1969 (CITA) and applies to all taxpayers that are subject to Dutch corporate income tax (CIT).227

The Dutch tax system knows a broad range of interest deduction limitation rules. With the introduction of the earningsstripping rule, being a general interest deduction limitation rule, two specific interest deduction limitation rules have been abolished as of 2019. While the earningsstripping rule applies to all (related party and third-party) debt, intra-group loans may furthermore fall within the scope of a specific anti-base erosion provision. Under this provision interest deduction is denied in respect of intra-group loans relating to certain tainted transactions, including the acquisition of a subsidiary (a related party to be). Exceptions may apply if both the transaction and loan are based on sound business reasons or if the interest is effectively taxed at a sufficient rate (10% in accordance with Dutch standards) at the creditor’s level.

According to the earningsstripping provisions, interest expenses of taxpayers are only deductible for CIT purposes up to an amount of 30% of the taxpayer’s EBITDA or €1 million, whichever is higher. The Netherlands applied for a strict implementation of the earningsstripping rule and opted out for nearly all exemptions that ATAD I228 provides for.

Non-deductible interest expenses may be carried forward without time limit and may be deductible in the future229. To avoid the transfer of the interest carryforward among taxpayers, the interest-carryforward is subject to the same principles as the loss-carryforward, including curtailment on change of shareholders. Any exceeding interest revenues, i.e. when interest revenues accrued in a tax period exceed the interest expenses, are not available for carry forward. Furthermore, Dutch tax law does not provide for a carry forward of any “excess of 30% EBITDA”, i.e. when the 30% EBITDA is higher than the net interest expenses.

13.2 DETERMINATION OF LOAN, INTEREST EXPENSE AND INTEREST INCOME

The earningsstripping rule applies to all interest expenses and other costs economically equivalent to interest, whether the debt is granted by a shareholder, related or third party.

Under Dutch tax law, the earningsstripping rule applies to exceeding interest expenses in respect of loans. Pursuant to article 15b, paragraph 8 CITA, loan, interest expenses and interest income are defined as follows:

• A loan is a receivable or debt position originating from a loan agreement or similar agreement;

• Interest expenses are the amount of interest expenses in respect of loans, including costs in respect of loans and in respect of legal actions undertaken to hedge interest rates and/or currency risks in respect of loans; and

• Interest income is the amount of interest income in respect of loans.

Hereafter we provide some further guidance on how to interpret the above stated definitions.

LOANS

The scope of the earningsstripping rule pursuant to ATAD I covers all kind of debt whereas article 15b CITA limits its application to loans. According to Dutch law, debt includes all legally binding obligations resulting from any existing legal relationships. The definition of debt is therefore broader than the concept of loan agreements or similar agreements.

Nevertheless, the Dutch State Secretary of Finance holds the view that the Dutch concept of loan is in line with the provisions of ATAD I.230

Convertible bonds and perpetuums will likely qualify as loan within the meaning of article 15b CITA.231 However, loans that are requalified to equity for tax purposes fall outside the scope of the earningsstripping rule.232

Specific arrangements such as financial leasing, (recourse) factoring and securities lending may also fall within the scope of the above-mentioned definitions and thus the earningsstripping rule.233

Interest expenses and interest income

The Netherlands applies an economic approach in determining the scope of interest expenses and interest income. Interest expenses and interest income in respect of loans include currency results in respect of loans, as well as results in respect of legal actions undertaken to hedge interest rates and/or currency risks in respect of loans.

Value changes (including write-off) of loans, as a main rule, fall outside the scope of the earningsstripping rule.234 The interest accrual of loans issued below par is considered an interest expense or interest income within the meaning of article 15b CITA.235

The earningsstripping rule applies also to capitalised interest expenses included in the balance sheet value of a related asset. In this regard, specific provisions are included in article 15b, paragraph 6 (d) and 7 CITA.

Interest expenses and income of a foreign CFC that fall within the scope of Dutch CFC legislation, are not taken into account when calculating the exceeding interest expenses under the earningsstripping rule.236

Costs in respect of loans are also considered an interest expense. Costs include, formalisation fees, advisory fees, brokerage fees, legal fees for drafting the loan agreement, registration fees, commissions, guarantee fees and penalty interest.237

13.3 DETERMINATION OF THE EBITDA

The EBITDA has to be adjusted for tax purposes (taxable EBITDA), i.e. exempt income such as dividends is therefore not taken into account. The taxable EBITDA is defined as taxable profit (before applying interest-limitation) less interest earnings plus interest expenses and expenses for depreciation and amortization.238

Application of the Dutch innovation box regime (partial base exemption) lowers the taxable EBITDA.

13.4 EXEMPTIONS FROM THE INTEREST LIMITATION RULE

ATAD I provides for various exemptions to the limitation of the deductibility of interest under the earningsstripping rule. As said, the Dutch legislator opted for a very strict implementation of the earningsstripping rule. The only exemption to the limitation is when the exceeding interest expenses for the fiscal year are less than €1 million per taxpayer.

227 Article 2 CITA.
229 Article 15b, paragraph 5 CITA.
230 Kamerstukken II, 2018-2019, 35 030, nr. 3.
236 Kamerstukken II 2018-2019, 35 030, nr. 3.
As such, neither of the following escapes have been implemented in the Dutch CITA:

i. Stand-alone taxpayers;
ii. Equity escape;
iii. Group escape;
iv. Financial institutions exclusion;
v. Project financing exclusion;
vi. Grantfathering legislation.

13.5 DEDUCTIBILITY OF INTEREST EXPENSES IN CASE OF TAX CONSOLIDATION

In case of tax consolidation, the tax group (a so-called fiscal unity), is treated as one taxpayer and the earnings stripping rule is applied at fiscal unity level. The €1 million limit is applicable only once for the whole tax group. The Dutch State Secretary of Finance acknowledged that taxpayers may split up to benefit multiple times from the €1 million limit. When this situation materialises, legislation targeting the splitting up of fiscal unity’s may be introduced.239

14 DUTCH IMPLEMENTATION OF THE ATAD ANTI-HYBRID RULES

14.1 INTRODUCTION

Over the recent years, the Dutch government has made substantial efforts in order to improve the country’s reputation as attractive economy for global and European headquarters. These efforts where driven by the public debate on aggressive tax planning - fuelled by publications like the Panama and Paradise Papers - throughout which the Netherlands was perceived as facilitator of international tax avoidance and evasion schemes.

Having this in mind, the Dutch government took a pro-active and cooperative approach in the OECD BEPS project and related fiscal EU initiatives. This included rapid signing of the OECD Multilateral Instrument in order to allow for the BEPS-inspired update of its tax treaty network, but also swift implementation of the EU Directives implementing the European Commission’s and OECD recommendations against the use of hybrid mismatches.

In 2015, the Dutch government implemented the EU Directive 2014/86/EU of 8 July 2014 (PSDII) (amending the EU Parent/Subsidiary), leading to non-applicability of the Dutch participation exemption on income which is tax deductible at the level of the payer (PSD II).

As the European Commission converted the OECD BEPS recommendations into EU Directives in order to secure coordinated implementation throughout the European Union, the Dutch government implemented EU Directive 2016/1164 on 12 July, 2016 (ATAD I) per 1 January 2019 and the EU Directive 2017/952 of 29 May, 2017 regarding hybrid mismatches (ATAD II) per 1 January 2020 – with selected parts per 2022.

14.2 DUTCH IMPLEMENTATION LEGISLATION

Focusing on anti-hybrid measures, the implementation legislation of the various EU Directives introduced the following key articles in the Dutch CITA:

- Article 13(17) CITA on the non-applicability of the participation exemption on income which is tax deductible at the level of the payer (PSD II).
- Article 12aa-12ag CITA on the non-deductibility of payments on hybrid instruments and to/from hybrid entities (ATAD II).
- Article 2 sub 3 CITA on the reverse hybrid entity measure, applicable per 2022.

In general, the Dutch implementation legislation closely followed the respective EU Directives. Where options were available, the Dutch government generally opted for the strictest option.

A few specific Dutch items should be noted:

- Beyond the scope of ATAD II, the Dutch government introduced an obligation for taxpayers to document their anti-hybrid positions under ATAD II.
- Under Dutch tax rules on the tax qualification of partnerships, foreign partnerships are generally considered non-transparent from a Dutch perspective. In general, partnerships are only considered transparent if the partnership agreement contains specific ‘unanimous consent’ provisions on the admission and transfer of limited partnership interests. This element, together with the imported mismatch rule, may result in unexpected deduction/non-inclusion and reverse hybrid scenarios.

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14.4 ARTICLE 12AA-12AG CITA
OVERVIEW
Article 12aa-12ag CITA cover the key anti-hybrid rules from both ATAD I and ATAD II. The following list summarizes the payments or structures which can lead to Dutch tax consequences:

- Article 12aa sub 1(a) CITA: deduction/non-inclusion with regard to financial instruments;
- Article 12aa sub 1(b) CITA: deduction/non-inclusion with regard to payments to hybrid entities;
- Article 12aa sub 1(c) CITA: deduction/non-inclusion with regard to differences in the allocation of payments between head office and/or permanent establishment(s);
- Article 12aa sub 1(d) CITA: deduction/non-inclusion with regard disregarded permanent establishments;
- Article 12aa sub 1(e) CITA: deduction/non-inclusion with regard to payments by hybrid entities;
- Article 12aa sub 1(f) CITA: deduction/non-inclusion with regard to notional payments between head office and/or permanent establishment(s);
- Article 12aa sub 1(g) CITA: double deduction mismatches
- Article 12ad CITA: imported mismatches
- Article 12ag CITA: documentation obligation

STRUCTURE
Article 12aa sub 1 limits the scope of ATAD II to hybrid mismatches caused:

1. between taxpayer and a related entity (directly or indirectly 25%);
2. between head office and permanent establishment;
3. between two or more permanent establishments which share a head office;
4. by way of a structured arrangement (unrelated entities causing a hybrid mismatch of which the benefits are taken into account in conditions of the pricing).

If a hybrid mismatch falls within the scope of one of the above-mentioned scenarios and results in a deduction and non-inclusion, the primary rule determines that the deduction should be denied. As such, article 12aa sub 1 is the implementation of the primary rule of ATAD II. The examples provided in the paragraphs hereafter, all explain the primary rule.

In case the payer is resident in a jurisdiction which does not have anti-hybrid rules (i.e. non-EU countries) the secondary rule determines that the State of residence of the payee should include the income in its taxable base. This is laid down in article 12ab CITA. Furthermore, to prevent that structures are being implemented to avoid the anti-hybrid rules by using non-EU jurisdictions, article 12ad CITA denies the deduction of payments in relation to imported hybrid mismatches.

ARTICLE 12AA SUB 1(A) CITA: DEDUCTION/NON-INCLUSION WITH REGARD TO HYBRID FINANCIAL INSTRUMENTS
This article covers hybrid mismatches in relation to financial instruments. A financial instrument is qualified as such in case it results in a return on equity or financing, such as shares and loans. The financial instrument is hybrid if the payment is tax deductible at the level of the payer but not-taxed – or not taxed within a reasonable time - at the level of the payee as a result of the difference in qualification of the financial instrument.

EXAMPLE

In this example BV issues a financial instrument to B Co, a resident of a non-EU jurisdiction. B Co receives a remuneration. For Dutch tax purposes the instrument is qualified as a loan and the payment as a deductible interest expense. For tax purposes of State B, the instrument is qualified as equity and the payment - qualified as a dividend - is exempt under a participation exemption. This results in a deduction and non-inclusion of the payment.

In this case the Netherlands shall deny the interest deduction. The income is exempt at the level of B Co and as such the income shall not be taxed within a reasonable time and the deduction and non-inclusion is the result of a difference in qualification of the instrument.

A reasonable time is defined as a tax period that starts within 12 months of the end of the tax period in which the payment has been deducted. Please note that in case it can reasonably be expected that the payment will be included in the tax base of the payee in a future tax period and the payment conditions of the hybrid instrument are at arm’s length, the payment could still qualify as taxed within a reasonable time.

The non-inclusion can also be the result of an entity not being subject to a profit tax, being eligible for a preferential regime or the country of residence not having a profit tax.
As the non-inclusion in these cases is not the result of a difference in qualification of the instrument, article 12aa, sub 1(a) CITA is not applicable.

In paragraph 14.3 we touched upon the anti-hybrid rule of the PSDII. If B Co would be a Dutch tax resident in the above-mentioned example and BV would be a tax resident of State B, the Dutch participation exemption would not be applicable if State B would allow the deduction. This is however not based on the secondary rule of article 12ab CITA, but based on article 13, paragraph 17 CITA. As such, this instrument does not fall within the scope of a hybrid financial instrument according to ATADII. This means that there is no documentation obligation for this type of transaction.

**ARTICLE 12AA SUB 1(B) CITA: DEDUCTION/ NON-INCLUSION WITH REGARD TO PAYMENTS TO HYBRID ENTITIES**

Payments to a hybrid entity are non-deductible according to Article 12aa sub 1(b) CITA. A hybrid entity is an entity which is qualified as transparent for one country and opaque for the country of its participants. In case an entity is transparent, the income it receives is attributed to its participants. If the country of which the participants are resident, qualify the entity as opaque, the income is attributed to the entity. The difference in the attribution of the income in the state of residence of the hybrid entity and the state of residence of its participants, results in non-inclusion of the income in both states.

**EXAMPLE**

In this example, the CV is a transparent entity for Dutch tax purposes, meaning that the payment is attributed to its participant in the United States. The United States however treat the CV as an opaque entity and attributes the income to the CV. This results in a deduction and non-inclusion of the income. In this case the Netherlands will deny the deduction of the payment.

As per 2022, this transaction will fall within the scope of article 1 sub 3 and sub 12 CITA. Reference is made to paragraph 14.5.

**ARTICLE 12AA SUB 1(C) CITA: DEDUCTION/NON-INCLUSION WITH REGARD TO DIFFERENCES IN THE ALLOCATION OF PAYMENTS BETWEEN HEAD OFFICE AND/OR PERMANENT ESTABLISHMENT(S)**

Article 12aa sub 1(c) CITA is applicable to payments to an entity with one or more permanent establishments, if the State where the entity is resident attributes the payment to a permanent establishment in another jurisdiction and the latter attributes the payment to the jurisdiction where the entity (head office) is a resident. This results in a deduction and non-inclusion of the payment.

**EXAMPLE**

In the example BV pays interest to B Co. State B however attributes this payment to B Co’s permanent establishment in State C, whereas State C attributes the payment to B Co in State B. As the payment is neither included in B Co’s nor in PE’s taxable base, the Netherlands will deny the interest deduction at the level of BV.

Please note that this is only the case if State B applies an exemption method. In case of a credit method, State B will, normally, levy additional tax.

**ARTICLE 12AA SUB 1(D) CITA: DEDUCTION/NON-INCLUSION WITH REGARD DISREGARDED PERMANENT ESTABLISHMENTS**

Article 12aa sub 1(d) CITA is just slightly different from article 12aa sub 1(c) CITA. This article covers a payment which is attributed to a permanent establishment that is disregarded in one State whereas the other State provides for an exemption of the payment. This results in a deduction and non-inclusion and is caused by States having different permanent establishment definitions.

**EXAMPLE**

In the example BV1 is an opaque entity for Dutch tax purposes, but for State A’s tax purposes BV1 is a transparent entity. State A does not take the income into account as it sees a payment from A Co to A Co. In the Netherlands this payment would be deductible, as it is a payment from one entity to another. This results in a deduction and non-inclusion and therefore the Netherlands will deny the deductibility of the payment.

This type of structure was beneficial if BV2 was profitable and BV1 lossmaking. Due to the fiscal unity regime BV1 and BV2 could offset their profits and losses. In case BV1 was profitable, its profits would be taxable in both the Netherlands as in State A. As said, the Netherlands does no longer allow for the deduction of the payment and as such this structure has lost its merits.

**ARTICLE 12AA SUB 1(E) CITA: DEDUCTION/ NON-INCLUSION WITH REGARD TO PAYMENTS BY HYBRID ENTITIES**

In paragraph 14.5 we discussed the payment to hybrid entities. Article 12aa sub 1(e) CITA denies the deduction of payments by hybrid entities, in case the payment is not taxed in the State of the payee due to the difference in qualification of the payer. In case the State of the payee qualifies the payer as transparent, that State does not take the payment into account. If the State of the payer however qualifies the payer as opaque, the payer can take a deductible payment into account. This results in a deduction and non-inclusion.

**EXAMPLE**

In the example BV1 is a tax resident of State B, the Dutch participation exemption would not be applicable if State B would allow the deduction. This is however not based on the secondary rule of article 12ab CITA, but based on article 13, paragraph 17 CITA. As such, this instrument does not fall within the scope of a hybrid financial instrument according to ATADII. This means that there is no documentation obligation for this type of transaction.
ARTICLE 12AA SUB 1(f) CITA: DEDUCTION/NON-INCLUSION WITH REGARD TO NOTIONAL PAYMENTS BETWEEN HEAD OFFICE AND/OR PERMANENT ESTABLISHMENT(S)

Article 12aa sub 1(f) CITA denies the deduction of notional payments by a permanent establishment resident in the Netherlands, if these payments are not included in the tax base of the State where the head office is located.

The Dutch State Secretary of Finance has issued a Decree in 2011 in which rules are laid down with respect to attribution of profits between permanent establishments and their head office. This Decree explains the profit allocation according to the Authorized OECD Approach (AOA) and therefore the Netherlands denies the deduction and non-inclusion and therefore in its taxable base. This would result in a mismatch relating to a financial instrument. A Co as a result of hybridity of the financial instrument to provide a non-deductible payment as well. The interest would be deductible at the level of BV. Without article 12ad CITA, the interest would be deductible at the level of BV, as B Co includes the payment in its taxable base. However, the interest that B Co receives on the non-hybrid loan is not subject to taxation.

EXAMPLE

In this example BV has a permanent establishment in State A. BV obtains a loan from a third party (Bank) and pays interest to the third party. State A attributes the loan in full to PE and thus allows for the interest as a deductible payment as well. The Netherlands does not attribute the loan in full to PE (Dutch tax law prescribes the same debt equity ratio for the head office as for the permanent establishment) and allows for a partial deduction at the level of BV.

This results in a double deduction and therefore the Netherlands denies the deduction on the interest as article 12aa sub 1(g) prescribes that the State of the head office should deny the deduction.

ARTICLE 12AD CITA: IMPORTED MISMATCHES

The anti-hybrid rules are only implemented by EU member states, which results in certain transactions not being tackled by the primary rule (article 12aa CITA) or the secondary rule (article 12ab CITA). The imported hybrid mismatch rule was introduced (implemented in Dutch tax law in article 12ad CITA) to prevent that abusive (including e.g. diversion) structures are being implemented to avoid the anti-hybrid rules.

EXAMPLE

In this example A Co and B Co entered into an agreement which results in a hybrid mismatch relating to a financial instrument. B Co can deduct the payment (e.g. because it is resident outside the EU), whereas A Co does not include the payment in its taxable base. The mismatch is the result of a difference in qualification of the financial instrument between both States. B Co used the financial instrument to provide a non-hybrid loan to BV. Without article 12ad CITA, the interest would be deductible at the level of BV, as B Co includes the payment in its taxable base. However, the interest that B Co receives on the non-hybrid loan is not subject to taxation.

In this case, (no taxation at the level of BV) B Co can deduct the payment (e.g. because it is resident outside the EU), whereas A Co does not include the payment in its taxable base. The mismatch is the result of a difference in qualification of the financial instrument between both States. B Co used the financial instrument to provide a non-hybrid loan to BV. Without article 12ad CITA, the interest would be deductible at the level of BV, as B Co includes the payment in its taxable base. However, the interest that B Co receives on the non-hybrid loan is not subject to taxation.

In this example B Co can deduct the payment (e.g. because it is resident outside the EU), whereas A Co does not include the payment in its taxable base. The mismatch is the result of a difference in qualification of the financial instrument between both States. B Co used the financial instrument to provide a non-hybrid loan to BV. Without article 12ad CITA, the interest would be deductible at the level of BV, as B Co includes the payment in its taxable base. However, the interest that B Co receives on the non-hybrid loan is not subject to taxation.

Based on article 12ad CITA, in such situation consideration needs to be given to the position of B Co as if it was in the position of BV. In that case, (no taxation at the level of A Co as a result of hybridity of the financial instrument) the interest would be non-deductible at the level of BV.

The number of interposed entities is not relevant as long as all entities involved are related or if it is a structured arrangement and the transactions result in a deduction and non-inclusion of the same income.

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14.5 ARTICLE 2 SUB 3 AND SUB 12 CITA: REVERSE HYBRID

Where article 12aa CITA up to 12ag CITA combat the hybrid mismatches by way of eliminating the tax benefit, either by denying the deduction or by including the income, article 2 sub 3 CITA in combination with article 2 sub 12 CITA, eliminate the cause of the mismatch by treating a (in principle) transparent partnership as opaque for Dutch tax purposes, thus following the qualification of the State where the participant(s) are resident – or most of them, as structures often have participants in different States. This results in the Dutch (in principle transparent) partnership becoming subject to Dutch corporate income tax.

Applicable per 2022, this rule will mostly apply to Dutch limited partnerships which qualify as transparent from a Dutch tax perspective, with voting / profit rights held for 50% or more by related limited partners which qualify the partnership as non-transparent.