



## EU Direct Tax Newsalert

### ATAD II Directive formally adopted

On 29 May 2017, the EU's Council (in the Competitiveness Council configuration) formally adopted the Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (ATAD II) without further discussion. The amended Directive (ATAD II) has a broader scope than ATAD I as it also covers hybrid mismatches with third countries and more categories of mismatches. The formal adoption of ATAD II follows the political agreement reached by EU Member States in the ECOFIN Council already on 21 February 2017 and the opinion of the European Parliament issued on 27 April 2017.

#### Background

During the ECOFIN Council meeting of 12 July 2016, when ATAD I was adopted, a request was put forward for an EC proposal on hybrid mismatches involving third countries as well in order to provide for rules consistent with and no less effective than the rules recommended by the OECD BEPS report on Action 2. The terms and concepts contained in ATAD II are very similar to those in the OECD's BEPS Action 2 recommendation. Explicit mention is made in the preamble of ATAD II to the explanations and examples contained in the OECD recommendation which should be used "as a source of interpretation" insofar as they are consistent with EU law.

#### Key provisions of ATAD II

- **Scope:** where ATAD I includes rules on hybrid mismatches between Member States (MSs), ATAD II adds rules on mismatches with third countries that apply to all taxpayers subject to corporate tax in one or more MSs, including permanent establishments (PEs) in one or more MSs of entities resident for tax purposes in a third country. Rules on reverse hybrid mismatches also apply to entities treated as transparent for tax purposes by a Member State (MS).
- **Hybrid mismatch definition:** ATAD II extends the hybrid mismatch definition of ATAD I which covers situations of double deduction or deduction without inclusion resulting from hybrid entities or hybrid financial instruments to include mismatches resulting from arrangements involving PEs, hybrid transfers, imported mismatches and reverse hybrid entities. ATAD II also includes rules on tax residency mismatches. Mismatches that pertain to hybrid entities are only covered where one of the associated enterprises has effective control over the other associated enterprises. Deduction without inclusion arising due to the tax (exempt) status of a payee or the fact that an instrument is held subject to the terms of a special regime is not to be treated as a hybrid mismatch.
- **Double deduction:** to the extent that a hybrid mismatch results in double deduction, the deduction shall be denied in the investor MS or, as a secondary rule, in the payer MS. Nevertheless, any deduction shall be eligible for off-setting

against dual inclusion income now or in the future.

- **Deduction without inclusion:** to the extent that a hybrid mismatch results in a deduction without inclusion, the deduction shall be denied in the payer MS or, as a secondary rule, the amount of the payment shall be included as taxable income in the payee MS.
- **Imported mismatch:** An imported mismatch arises where an entity (the payee) sets off a hybrid mismatch payment against an otherwise taxable receipt arising on a payment from the payer. The mismatch is "imported" into the payer jurisdiction and the payer is denied a deduction for the payment. The taxpayer MS shall deny a deduction to the extent a hybrid mismatch is imported.
- **Disregarded PE income:** the MS in which the taxpayer is tax resident shall require income inclusion to the extent a hybrid mismatch involves disregarded PE income, unless a double tax treaty concluded with a third country requires exemption of the income.
- **Hybrid transfer:** to the extent a hybrid transfer is designed to produce withholding tax relief to more than one of the parties involved, the taxpayer MS shall limit the relief in proportion to the net taxable income regarding the payment.
- **Reverse hybrid:** a hybrid entity shall be regarded as a resident of the MS of incorporation or establishment and taxed on its income to the extent this income is not otherwise taxed. This rule shall not apply to collective investment vehicles.
- **Tax residency mismatches:** to the extent dual (or more) tax residency results in double deduction, the taxpayer MS shall deny deduction insofar as the duplicate deduction is set-off in the other jurisdiction against non-dual-inclusion income. If both jurisdictions are MSs, the loser State under the residency tie-breaker rule of the relevant double tax treaty shall deny the deduction.
- **Options for exclusion:** MSs may e.g. under certain conditions and temporarily exclude hybrid mismatches resulting from intra-group instruments issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements (e.g. regulatory hybrid capital).

#### Next steps

MSs will need to transpose the provisions of ATAD II by 31 December 2019 and apply them per 1 January 2020. This applies to both mismatches between MSs and between MSs and third countries. By way of derogation, the reverse hybrid entity rule (requiring taxation of income to the extent not otherwise taxed) will need to be transposed by 31 December 2021 and applied per 1 January 2022. Payments to reverse hybrids will however not be deductible anymore from 1 January 2020.

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For more detailed information, please do not hesitate to contact:

Hein Vermeulen  
PwC Netherlands  
+31 (0)88 792 75 21  
[hein.vermeulen@nl.pwc.com](mailto:hein.vermeulen@nl.pwc.com)

Jonathan Hare  
PwC United Kingdom  
+44 (0)20 7804 6772  
[jonathan.hare@uk.pwc.com](mailto:jonathan.hare@uk.pwc.com)

Bob van der Made  
PwC Netherlands  
+31 6 130 96 296  
[bob.van.der.made@nl.pwc.com](mailto:bob.van.der.made@nl.pwc.com)

Or your usual PwC contact

