



## EU Direct Tax Newsalert

### ATAD II: political agreement in ECOFIN Council

On 21 February 2017, the EU 28 Finance Ministers in the ECOFIN Council meeting reached agreement on a general approach to the Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (ATAD II) with a view to adopting it, subject to receiving the opinion of the European Parliament and legal-linguistic revision.

#### Background

The European Commission (EC) presented its proposal for ATAD II as part of the Corporate Tax Reform Package of 25 October 2016. This ATAD II proposal responded to a ECOFIN Council request made during the meeting of 12 July 2016, when Directive (EU) 2016/1164 on rules against tax avoidance (ATAD I) was adopted, to put forward a proposal on hybrid mismatches involving third countries in order to provide for rules consistent with and no less effective than the rules recommended by the OECD BEPS report on Action 2. Indeed, the terms and concepts contained in ATAD II are similar to those in the OECD's Action 2 report.

#### 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 all entities treated as transparent for tax purposes by a 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. In addition, ATAD II includes rules on tax residency mismatches. Mismatches covered are only those that arise between head office and PE, between PEs, between associated enterprises and those resulting from structured arrangements. 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 set-off 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:** 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 not subject to tax in that MS, 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 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

After finalisation, ATAD II will be submitted for formal adoption at a forthcoming ECOFIN Council meeting after the European Parliament has formally issued its opinion on the EC proposal, which is currently scheduled for 26 April 2017.

Once formally adopted, MSs will need to transpose the provisions 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 specific reverse hybrid entity rule (requiring taxation of income to the extent not otherwise taxed) would need to be transposed by 31 December 2021 and applied per 1 January 2022, however payments to reverse hybrids would not be deductible anymore from 1 January 2020.

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