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The Hybrid Financial Instruments: The Effects of the OECD BEPS Action 2 Report and the ATAD

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This contribution critically assesses the complex hybrid mismatch rule concerning financial instruments as developed under the OECD BEPS action 2-proposal and subsequently implemented in the Anti-Tax Avoidance Directive (ATAD). Both approaches are compared, starting with a profound analysis of the OECD initiative. Given their obligation to implement the European initiative in domestic tax law by 1 January 2020, domestic legislatures now have to deal with the exact meaning of the Directive. However, the ambiguous text incites uncertainties and will definitely raise incoherencies between the several EU-Member States.

Both international initiatives clearly rather aim to counter tax avoidance, instead of creating coherencies: only double non-taxation is envisaged and the taxpayer is confronted with a rather technical, hierarchical set of rules increasing his tax burden, because of an objective incoherent outcome. The solution is hardly inspired by the fundamental idea of BEPS to tax income where it has been generated. Given this rather mechanical approach the question is finally raised whether restrictions on the freedom of establishment and the free movement of capital can be justified. However, as this article focuses on the task for domestic legislators, this ultimate question has not been substantially investigated.

Keywords: hybrid mismatches, BEPS, ATAD, financial instruments

I INTRODUCTION

1. In addition to the classical forms of financial instruments (equity, debt, etc.), hybrid financial instruments have become very important in the last decades. They are increasingly used to reduce the global tax burden especially in the context of international tax optimization. Particular arrangements exploit differences in the tax treatment of financing instruments or value transfers between two or more countries. They often lead to a non-intended ‘double non-taxation’ or may alternatively defer a tax debt which, if maintained over several years, is economically similar to double non-taxation.1 These types of arrangements can be considered as forming a component of the more general concept of ‘aggressive tax planning’. Because several different definitions do exist,2 we prefer to use this term as a vague concept focusing on behaviour in general that might be challenged by national legislators as conflicting with their tax policies.

2. The role played by hybrid mismatch arrangements in aggressive tax planning has been discussed in several OECD reports. Even before the outcome of the BEPS Action Plan in 2010, the OECD recommended revenue bodies to ‘bring to the attention those situations where the same tax loss is relieved

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2 E.g. J. M. Calderón Carreño & A. Quintas Seara, The Concept of ‘Aggressive Tax Planning’ Launched by the OECD and the EU Commission in the BEPS Era: Redefining the Border Between Legitimate and Illegitimate Tax Planning, 44(3) Intertax 210 (2016); Calderón Carreño & Quintas Seara refer to ‘a new tax policy guiding principle that helps to define the paradigm shift and the new way of understanding international taxation based on a supranational level, but without ruling out possible applications through the interpretation of the new approach that will guide all international (and national) regulations adopted in the “post-BEPS era”’, A. P. Dourado, Aggressive Tax Planning in EU Law and in the Light of BEPS: the EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6, 43(1) Inter Tax 44 (2015). According to Dourado the concept aggressive tax planning is an umbrella concept to both international tax planning and tax avoidance to define the concept of aggressive tax planning’. P. H. J. Essers, International Tax Justice Between Machiavelli and Habermas, 68(2) Bull. Int’l Tax’n 57 (2014). Essers states that it is ‘a very vague concept which blurs the fundamental differences between legal tax planning, tax avoidance and tax fraud’. The tax administrations may use aggressive tax planning in a Machiavellian sense.

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INTERTAX, Volume 48, Issue 1
in more than one country as a result of differences in tax treatment between jurisdictions, in order to determine whether steps should be taken to eliminate that arbitrage/mismatch opportunity. In 2011, it was recommended to consider introducing restrictions on the multiple deduction of the same economic loss through the use of hybrid mismatches. A 2012 report finally summarizes tax policy issues that are raised by hybrid mismatch arrangements and describes the policy options in domestic tax law to address them. When launching the BEPS Action Plan, international mismatches in relationship to the classification of entities and financial instruments were recognized as one of the most important key pressure areas that can potentially lead to (unintended) double non-taxation or long-term tax deferral.

The issue has finally been taken up under OECD BEPS Action 2. The final BEPS Action 2 Report provides several recommendations from both domestic and treaty perspectives to tackle the unintended outcome of double non-taxation caused by hybrid mismatches as will be further explained in this contribution.

3. The OECD recommendations have also been applied on a European level by the European Commission: as a response to the BEPS Action Plan, the European Commission adopted an ‘Action Plan for a Fair and Efficient Corporate Taxation’ in June 2015. This was further adapted in an Anti-Tax Avoidance Package of 28 January 2016 containing measures to prevent aggressive tax planning, encourage tax transparency, and create a level playing field for all businesses in the EU. A key element in this package was the proposal for an Anti-Tax Avoidance Directive (ATAD), containing six measures that all Member States should apply against common forms of aggressive tax planning. Five of them were ultimately withdrawn in the accepted Council Directive (EU) 2016/1164 (ATAD I). One provision, Article 9, also focused on addressing hybrid mismatches between EU Member States; however, the work on them was only partially completed. The Council on economic and financial affairs (ECOFIN) Council issued a statement on 12 July 2016 requesting the Commission to introduce 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 with the intention of reaching an agreement by the end of 2016. After agreement between the Member States on 21 February 2017, the Commission’s proposal of 25 October 2016 led to the adoption of the ATAD II that reformed the ATAD I with regard to hybrid mismatches on 29 May 2017.

4. This contribution will provide a critical comprehensive analysis of the complex hybrid mismatches rules concerning financial instruments.

### Notes


7 OECD, *Hybrid Mismatch Arrangements*, supra n. 1.

8 For example, harmonization of domestic laws, general anti-avoidance rules, specific anti-avoidance rules, and rules specifically addressing hybrid mismatch arrangements.

9 In margin nr. 8, we will reveal that the meredouble non-taxation is envisaged as an objective situation to be combated. This implies that the mere outcome of double non-taxation is unintended without any subjective aim of the taxpayer having to be taken into account.


11 OECD BEPS Action 2 Final Report, supra n. 1.


Challenging the compatibility of ATAD with the OECD initiative, we will illuminate the differences between both approaches and identify risks of conflicting domestic implementations caused by remaining uncertainties of this hybrid financial instrument rule. As EU-Member States had to transpose the provisions of the hybrid financial instrument rule by 31 December 2019 and apply them per 1 January 2020\textsuperscript{15}, 2019 was the year that domestic legislators had to confront existing domestic rules with these requirements.

Before beginning our analysis, we will first delineate the precise scope of these rules. It remains remarkable that, although they focus on mismatches in domestic legislation, creating coherence is not the genuine goal of these rules. They rather aim to combat perceived abuses that the taxpayer, being confronted with incoherent legal systems, is blamed for.

2 Hybrid financial instrument rule as an anti-tax avoidance measure

5. The precise scope of the hybrid financial instrument rule leaves several ambiguities: a ‘hybrid financial instrument’ is not inherently defined, only tax reducing effects appear to be envisaged, and the mere obtaining of a benefit does not necessarily reflect the intent of a concerned taxpayer to actively avoid paying taxes. These three general aspects will be further explained before focusing on the technical constraints themselves.

6. Although definitions exist for a ‘financial instrument’,\textsuperscript{16} a ‘hybrid financial instrument’ is not commonly defined. It concerns an instrument that is classified differently in the domestic law of various countries. Classic examples of a hybrid financial instrument are redeemable preference shares, profit participating loans, subordinated debentures, convertible debts, and perpetual debts.

The OECD seems to describe hybrid [financial] instruments as ‘instruments which are treated differently for tax purposes in the countries involved, most prominently as debt in one country and as equity in another country’.\textsuperscript{17} As the definition of the OECD is rather general, a more tangible description of the term ‘hybrid financial instrument’ would certainly be appreciated. According to previous legal doctrine,\textsuperscript{18} there are two approaches to identify ‘hybrid financial instruments’. The ‘first approach’ contains only a reference to specific elements of both debt and equity capital without requiring different tax treatment. A ‘second approach’ defines these types of instruments as a mixture between debt and equity capital that can result in a different tax treatment of the same instrument. The various approaches prove why one generally accepted definition of the term hybrid financial instrument is rather difficult to make. In our opinion, a hybrid financial instrument should be defined as ‘an instrument that has (economic) characteristics that are inconsistent, in whole or in part, with the legal (more specific: tax) qualification of the instrument and hence the tax treatment of the payments under it\textsuperscript{19} that may lead to double non-taxation or double taxation’.\textsuperscript{20} Therefore, we adhere to the second approach.

7. The OECD hybrid mismatch rule (as well as its European successor under the ATAD) targets financial instruments whereby mismatches are typically the result of (technical) differences in the way jurisdictions tax the payments under these instruments (debt or equity) rather than because of dissimilarities in the way that the instrument itself is legally tax treated.

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\textsuperscript{15} Art. 11, ¶5a ATAD. Under ATAD I implementation of the hybrid mismatch rules had been foreseen by 31 Dec. 2018. ATAD II extended the delay by one year. By way of derogation, the specific reverse hybrid entry rule of Art. 9a ATAD (requiring taxation of income to the extent not otherwise taxed) would need to be transposed by 31 Dec. 2021 and applied per 1 Jan. 2022. Nonetheless, payments to reverse hybrids would no longer be deductible beginning 1 Jan. 2020. It remains remarkable to notice that this additional delay, foreseen in Art. 2, ¶3 ATAD II has not been added as an amendment in the text of ATAD I.

\textsuperscript{16} OECD BEPS Action 2 Final Report, supra n. 1, Recommendation 1.2., 23 and Art. 2, ¶9, al. 3; 1) ATAD.

\textsuperscript{17} OECD, Hybrid Mismatch Arrangement, supra n. 1. It is mentioned that ‘hybrid mismatches mainly arise because of conflicts of qualification, from either a treaty or domestic perspective, and even from both perspectives combined, in different jurisdictions’. In this context, the Commentaries of the OECD Model Tax Convention describe hybrid financing as ‘some kind of hidden capitalization or hidden equity capitalization’, as OECD, Model Tax Convention on Income and on Capital 2014 B4/5 (OECD Publishing 30 Oct. 2015), www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-2015-full-version-9789264239081-en.htm (accessed 14 Oct. 2019).


\textsuperscript{19} The conflict of qualification is due to the different legal understanding of the financial instrument and the income derived therefrom as debt or equity – interest and dividend – in different jurisdictions. The tax consequences of the characterization as debt and equity can differ substantially.

\textsuperscript{20} See also E. Jansen & E. van Kasteren, Hybrid Financial Instruments, 10(5) Derivatives & Fin. Instruments 175 (2008).
treated under common law. More particularly, it emphasizes that the international tax arbitrage is because taxpayers exploit mismatches in national tax laws regarding the treatment of flows of value under financial instruments. An arrangement seems to only be envisaged if the ‘hybrid mismatch arrangement’ causes a double non-taxation. A mismatch in tax outcomes leading towards extensive taxation due to characterization differences is not particularly considered. However, one of the key pillars of the OECD BEPS Action Plan (and the ATAD) was to introduce more coherence in the domestic rules that affect cross-border activities. Nonetheless, when focusing on financial instruments, double taxation due to mismatches no longer seems to be an issue to be addressed, although this could possibly not be avoided. As such, double taxation can arise when a financial instrument is treated as equity in the payer’s jurisdiction and as a debt instrument in the payee’s jurisdiction; the first State qualifies the payment as a non-deductible dividend while the latter State considers taxable interest being received.

8. The previous remark immediately reveals the last critical aspect. The hybrid mismatch rule is intended to counter tax avoidance. However, the mere fact of (corporate) taxpayers taking advantage of inconsistent treatment does not necessarily indicate that there is avoidance behaviour. First of all, the mere presence of double non-taxation in transactions between related parties already triggers the application of anti-hybrid regulations, although both the OECD and the EU state that only ‘unintended’ double non-taxation is problematic. An objective situation is, as such, envisaged. Moreover, the internal law aspects of either domestic legal system might be fully respected and not circumvented. From a unilateral domestic perspective, the purpose (or intention) of the law is not being defeated. It is solely the consequence of disparities between national tax systems (the proper allocation of the local law in cross-border situations) for which the taxpayer is blamed.

3 HYBRID FINANCIAL INSTRUMENTS UNDER THE BEPS ACTION 2 FINAL REPORT

3.1 General Remarks

9. First, we critically focus on the proposals of the OECD under the Final BEPS Action 2 report. Although its value cannot be neglected, these OECD initiatives are ultimately ‘only’ recommendations without any legal value. Moreover, even under the general outcome of the BEPS Action Plan, Action 2 was not considered to be an element of the accepted minimum standards that parties agreed to implement
in any case. Non-obligatory proposals to change tax treaties have been integrated into Articles 3 to 5 of the Multilateral Instrument, and the BEPS Action 2 proposals for domestic tax law are also not binding. The value of Article 9 ATAD is clearly different. The European integration of these recommendations in a directive made their implementation obligatory for the EU Member States. However, since the ATAD is based on the OECD proposals, we first begin with the OECD framework.

10. BEPS Action 2 has a broad scope regarding different types of hybrid constellations. In 2017, the final 2015 report was even further complemented with an additional report about branch mismatch arrangements. However, only hybrid financial instruments, as previously described, will be further addressed. Therefore, neither the additional 2017 report nor other aspects proposed for in the 2015 report will be discussed. This study is limited to the recommendations for the domestic law treatment of hybrid financial instruments.

3.2 Hybrid Financial Instrument Rule

11. The general philosophy of BEPS Action 2 departs from an expected tax outcome. Hybrid financial instruments can lead to a so-called (direct) D/NI outcome under which a payment is deducted in a payer jurisdiction but is not supposed to be included in the taxable income in the payee jurisdiction due to the hybrid mismatch. This outcome is combatted through a hierarchy of solutions referred to as ‘linking rules’. The primary rule denies the deduction for a payment under a financial instrument by the payer jurisdiction to the extent it generates a D/NI outcome. The (secondary) defensive rule requires such a payment to be included in ordinary income to the extent that the payment produces a D/NI outcome, and the deduction is not refused in the payer jurisdiction (Figure 1).

12. This rather direct set of rules is further complemented in the case of a third State financing the creation of this hybrid payment between two States that have not provided for any of the recommended rules. In this case, the third State is considered to have imported the mismatch and will refuse a deduction of a (regular) payment in as far as this has been set off against an expenditure under a hybrid mismatch arrangement (imported mismatch) (Figure 2).

13. In addition to the linking rules (and the imported mismatch rule), the OECD BEPS Action 2 Report also provides specific recommendations for the domestic tax treatment of financial instruments.

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52 These concern the right of a residence State to tax its own residents, the exclusion of dual residents from the scope of tax conventions unless a mutual agreement between tax administrations is concluded, and three options to adapt the obligation to provide relief in the case of mismatches. States always maintain the option of not integrating these proposals. (Cfr Art. 4, §5, a); 11, §5, a) and Art. 5, §8 MLI.)

53 Although not the subject of this contribution, it is relevant to notice that the hybrid financial instrument rule is clearly of significant interest to developed countries. See also R. S. Collin & N. Riedel, The OECD/G20 Base Erosion and Profit Shifting Initiative and Developing Countries, 72(12) Bull. Int’l Tax’n 709 (2018). According to Collin and Riedel, the hybrid mismatch rules are often concerned with the effects of highly structured tax planning i.e. not seen regularly in the context of developing countries. For more details regarding this topic, cf. OECD, Two-Part Report to G20 Developing Working Group on the Impact of BEPS in Low-Income Countries 1–72 (OECD Publishing, 2014), http://www.oecd.org/tax/tax-global/report-to-g20-beg-on-the-impact-of-beps-in-low-income-countries.pdf (accessed 14 Oct. 2019). However, the two-tiered approach with linking rules as well as the additional imported mismatch rule offers possibilities to react against the (abuse of) mismatches with financial instruments if a developing country was involved (Cfr. margin nrs. 31 ff).

54 OECD BEPS Action 2 Final Report, supra n. 1.

55 In this way, the OECD BEPS Action 2 Report does not need to address the characterization of the instrument itself. It merely recognizes the expected tax consequences of hybrid instruments. The hybrid mismatch rule links rules that seek to align the tax treatment of an instrument with the tax outcome in the counterparty jurisdiction ‘but [which] otherwise do not disturb the tax or commercial outcomes’, in OECD BEPS Action 2 Final Report, supra n. 1, at 11.

56 Abbreviation for ‘Deduction/Non-Inclusion’.

57 This implicitly covers a prior solution in the payer jurisdiction. The non-inclusion in this State can come from the qualification of the received payment as a dividend i.e. exempted from taxation. However, this exemption is sometimes submitted to the condition of the income not being deductible in the payer State. If, because of a deduction in the payer State, the payment is no longer exempted in the payee State, no mismatch arises, and no rules have to be applied. See OECD BEPS Action 2 Final Report, supra n. 1, Recommendation 2, at 45 ff.

58 This order immediately reflects a difference with the EU initiative. As the directive is binding upon the Member States, they will have to implement the primary rule. Therefore, the secondary rule will only become a factor when third countries are concerned.


60 The purpose is to prevent mismatches from arising by seeking to bring the treatment of the instruments into accordance with the tax policy outcomes that will generally apply to the same instruments in the domestic context. A payment under a hybrid financial instrument will not be treated as generating a D/NI outcome if the mismatch...
These recommendations suggest (1) that jurisdictions that offer an exemption for dividends do not extend that exemption to deductible payments and (2) that jurisdictions granting relief for tax withheld at its source on a payment made under a hybrid transfer should restrict the benefit of such relief in proportion to the net taxable income of the taxpayer under the arrangement. These measures, to a certain extent, reduce the relevance of the linking rules and the imported mismatch rules. Moreover, the scope of these (additional) recommendations is not limited to transactions between related parties and parties to structured arrangements. This differs from the general, and further analysed, hybrid financial instrument mismatch rule.

### 3.3 Scope of the Rule

14. The hybrid financial instrument rule applies to a ‘payment’ (and a substitute payment) between ‘related parties’ or under a ‘structured arrangement’ for a ‘financial instrument’ that results in a hybrid mismatch.

#### 3.3.1 Personal Scope

15. The personal scope of this rule is limited to payments that are made between related parties and payments that are made ‘under a structured arrangement whereby the taxpayer is party to that structured arrangement’. This scope once again substantiates the focus on tax avoidance, although a relation in

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**Notes**

41. OECD BEPS Action 2 Final Report, supra n. 1, Recommendation 2.1., at 45 ff.

42. The dividend exemptions are adopted to avoid double taxation of distributions of after-tax profits. However, the OECD BEPS Action 2 Report recognizes the problems that arise from the inclusion of the exemption method in tax treaties with regard to items of income that are not taxed in the payer’s jurisdiction.

44. OECD BEPS Action 2 Final Report, supra n. 1, Recommendation 2.2., at 45 ff.

45. The OECD BEPS Action 2 Report does not explicitly state that the scope of the hybrid financial instrument rule is limited to ‘taxpayers that are subject to corporate tax’. However, one of the key objectives of BEPS is to increase the coherence of corporate income taxation at the international level. The report further clarifies that a person established in a jurisdiction that does not impose a corporate income tax will not be treated as a taxpayer of that jurisdiction. See OECD BEPS Action 2 Final Report, supra n. 1, at nr. 425.
shareholder-ship does not automatically imply avoidance behaviour being at stake. It can be assumed that these conditions should be fulfilled at the time the payment is made (as the purpose of the OECD is to neutralize ‘the mismatch of a payment’ under a financial instrument).

3.3.1.1 Related Parties

16. In general, hybrid mismatch arrangements are within the scope of BEPS Action 2 if the parties to the mismatch are ‘members of the same control group’, i.e. if they form a part of the same consolidated group for accounting purposes, or a provision between them can be regarded as a provision between associated enterprises under Article 9 OECD Model Tax Convention, or if one person has a 50% investment or effective control over the other person (or a third person has this control over both). The rationale for requiring a 50% ownership threshold appeared to be related to the controlling influence that is required to determine the tax treatment at the level of hybrid entities themselves.

However, as far as hybrid financial instruments are concerned, this scope is further extended as the required threshold is reduced. Besides ‘members of the same control group’ related parties are also envisaged. This is considered to be the case if a person has a 25% or greater (direct or indirect) investment in another person (or a third person holds 25% in both). Reference is made to 25% of the voting rights or the value of any equity interests of that person.

17. To preserve the effectiveness of the rule and avoid tax planning schemes, an ‘acting-together’ measure is proposed. Persons acting together with another person in the capacity of ownership or control of any voting rights or equity interests will be treated as owning or controlling all of the voting rights and equity interests of that other person. They are required to aggregate their ownership interests for the purposes of the related party-test. This prevents taxpayers from avoiding this test by transferring their voting interest or equity interests to a different person who continues to act under their direction in relationship to those interests.

As such, a person will also be treated as holding the equity or voting interests of another person if both have entered into an arrangement regarding the ownership or control of those rights or interests. The measure encompasses both arrangements concerning the exercise of voting interests (such as the right to participate in any decision-making) as well as arrangements regarding beneficial entitlements (such as entitlement to profits or eligibility to participate in distributions).

3.3.1.2 Party to a Structured Arrangement

18. Additionally, the hybrid mismatch rule also applies to a taxpayer that is ‘a party to a structured arrangement’. This is a typical anti-avoidance measure aiming to capture those taxpayers that enter into agreements that (a) have specifically been designed to avoid the effect of the related party rules in order to produce a mismatch in tax outcomes or (b) when the hybrid mismatch is priced into the terms of the arrangement itself. The mere mismatch outcome is sufficient to qualify as a ‘structured arrangement’. The fact that an arrangement produces a combination of tax and commercial benefits does not necessarily prevent the arrangement from being treated as structured if an objective and well informed observer would conclude that part of the explanation for the design of the arrangement was to generate a hybrid mismatch.

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45 The accounting consolidation uses these principles in international financial reporting standards (IFRS) or in the applicable local generally accepted accounting principles (GAAP). For example, the IFRS 10 Consolidated Financial Statements will treat two or more persons as being related if the subsidiary is required to be consolidated on a line-by-line basis in the parent’s consolidated financial statements.

46 According to Art. 9 OECD Model Tax Convention, these are associations between the taxpayer and the counterparty for the purposes of transfer pricing. For transfer pricing purposes, two enterprises are associated if one of the enterprises ‘directly or indirectly’ participates in the management, control, or capital of the other or if the same persons participate directly or indirectly in the management, control, or capital of both enterprises (e.g. if both enterprises are under common control of a parent entity). As no further commentary is provided, this could still lead to different interpretations of the term ‘associated enterprises’ between countries.

47 Voting rights refer to the right to participate in any decision-making concerning a distribution, a change to the constitution or the appointment of a director. According to the OECD, the rights must be actual decision-making rights, e.g. a convertible bondholder who can elect, at any time, to convert his bonds into ordinary shares, or a shareholder who can elect to receive a dividend or a capital increase. Moreover, according to the OECD, the rights must be actual decision-making rights, e.g. a convertible bondholder who can elect, at any time, to convert his bonds into ordinary shares, or a shareholder who can elect to receive a dividend or a capital increase.

48 Voting rights are also envi-

49 An arrangement will include a number of separate arrangements that are part of the same plan or understanding. It will include all of the steps and transactions by which that plan or understanding is effectuated. See OECD BEPS Action 2 Final Report, supra n. 1, nr. 322, at 106.

50 See OECD BEPS Action 2 Final Report, supra n. 1, nr. 326, at 107.
The consequence is that a marketed tax-advantaged product could be in scope of the hybrid financial mismatch rules even if the parties are not related. A taxpayer can avoid being included in the hybrid mismatch rule if that person (also not any member of the same control group) 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 this mismatch.

19. The different actors must examine the ‘terms and conditions’ of an arrangement (and not only the transaction creating the mismatch in tax outcomes) in order to decide whether the facts and circumstances ‘indicate that the arrangement has been designed to produce a mismatch’ or whether a hybrid mismatch has been ‘priced into the terms of the arrangement’.

Due to its broad interpretation, the OECD sets out a list of facts and circumstances indicating that an arrangement has been designed to produce a hybrid mismatch. Unfortunately, these factors are not considered exclusive or exhaustive. Other factors in an arrangement may also lead to the conclusion that the arrangement has been designed to produce a mismatch in the tax outcomes.

A tax benefit of the mismatch will be priced into the (actual) terms and conditions of the arrangement ‘when the mismatch has been factored into the calculation of the return under the arrangement’. This will be the case, for instance, when the terms of the instrument explicitly provide for a formula that discounts what would otherwise have been a market interest rate by the amount of the tax benefit under the loan.

20. The test of whether a structured arrangement exists seems to be objective. It applies regardless of the intentions of the parties. However, the test is only based on what can reasonably be concluded from the terms of the arrangement and the surrounding facts and circumstances. It does not clearly identify when the mismatch has been priced into the terms of the arrangement or when the arrangement is designed to create a hybrid mismatch. The fact that other indications that date from before or after the hybrid payment may draw the conclusion that an arrangement is a structured arrangement will create uncertainty. Countries, therefore, might take a different approach to consider a financial arrangement as a ‘structured arrangement’ and to apply the hybrid financial mismatch rule.

21. A taxpayer can escape from being considered a party of a structured arrangement if that person was unaware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch. This is a combination of a so-called ‘knowledge-test’ and a ‘tax benefit-test’.

22. The knowledge-test is intended to capture those situations in which the taxpayer has the actual knowledge (or is reasonably expected to be aware) that the act conflicts with the purposes of the system or the legislative intentions regardless of whether that person has derived a tax advantage under that arrangement. This can be considered as what a reasonable and prudent person in the same position and in the same circumstances should have known. It is not necessary that the taxpayer undertakes additional due diligence (as the test is based on the information available to the taxpayer).

Even if the taxpayer is unaware of the existence of the hybrid mismatch arrangement, the actions of a
taxpayer’s agent will also be attributed to the taxpayer.\[^{64}\] This will be the case, for instance, when a beneficiary of a tax transparent trust receives distributions without knowledge of an existing hybrid mismatch, but the benefits are facilitated by the trustee. Although the beneficiary is not a direct party to the agreement concluded by the trustee, the tax consequences of the investment are imputed to the beneficiary. The trust’s status as a party to a structured arrangement is attributed to the beneficiary together with the payment. The beneficiary, therefore, is considered to be aware of the hybrid mismatch and cannot escape from the application of the hybrid financial instrument rule.\[^{67}\]

23. In addition to being unaware, a second test examines whether the taxpayer actually shared in the value of the tax benefit resulting from the hybrid mismatch.\[^{66}\] The OECD report provides the example of a back-to-back loan structured through an unrelated intermediary in order to provide a subsidiary with a subordinated debt financing. The tax benefit under the hybrid mismatch arrangement is returned to the parent company in the form of an above-market rate of interest.\[^{65}\] The tax administration does not need to establish that the taxpayer has actually received a benefit.\[^{68}\] It is the taxpayer, who is unaware of the existence of the mismatch, who bears the burden of proof that this individual did not share in the value of the tax benefit resulting from the hybrid mismatch.

### 3.3.2 Material Scope: Payments Under a Financial Instrument, Hybrid Transfers and Substitute Payments

24. The OECD BEPS Action 2 Report does not attempt to identify and define all of the transactions in which a hybrid mismatch could occur. Instead it formulates three different categories of ‘arrangements’\[^{69}\] dealing with financial instruments.

The first category focuses on a payment made under an arrangement providing for an equity or financing return. Although the payment is considered to be deductible, the income is not considered as ordinary income of the payee. The arrangement itself should qualify as a financial instrument under local law. Payments in execution of a sales contract, an asset transfer, or a contract for the assumption of non-financial risk are not targeted. Therefore, to define the first category of payments generating a D/NI outcome, a definition is needed of what is considered to be a ‘financial instrument’ and a ‘payment’ as well as when a payment can be considered being ‘made under’ a financial instrument.

Although payments for an asset transfer are generally not included in the scope of this rule, the transfer of a financial instrument can be organized in such a way that two jurisdictions take opposing opinions on who has the ownership of the underlying assets and is entitled to the financing or equity return of it. This will generate a second category of envisaged arrangements, for example, sale and repurchase transactions or securities lending transactions. The return of underlying assets will be attributed to one party (x). According to one jurisdiction’s (X) perspective, this will be the legal consequence of the ownership of that party (x). The other jurisdiction (Y), however, will consider this attribution as an additional (deductible) payment that is made by the legal owner of the assets (y) according to its legal qualification. This opposition results in a deductible payment for y, with no corresponding taxable income for x, based on the hybrid qualification of the transfer of the financial instrument. Defining this category requires a precise definition of a ‘hybrid transfer’.

Whereas the first two categories focus on arrangements that generate a hybrid outcome, the third and final category does not focus on the arrangement itself

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\[^{64}\] OECD BEPS Action 2 Final Report, supra n. 1, at 347 ff, at 112.

\[^{65}\] See OECD BEPS Action 2 Final Report, supra n. 1, Example 10.4, at 441.

\[^{66}\] Recommendation 10, OECD BEPS Action 2 report, at 105; Allen, supra n. 39, at 3–4. See also G. S. Cooper, Some Thoughts on the OECD’s Recommendations on Hybrid Mismatches, 69(6/7) Bull. for Int’l Tax’n 342 (2015). Cooper states that ‘there are practical difficulties in applying these rules to widely held instruments where the treatment of the payer might be contingent on the treatment of holders in many different states’.

\[^{67}\] OECD BEPS Action 2 Final Report, supra n. 1, Example 10.2, at 455.

\[^{68}\] OECD BEPS Action 2 Final Report, supra n. 1, at 345, at 111.

\[^{69}\] For a definition of the term ‘arrangement’, see OECD BEPS Action 2 Final Report, supra n. 1, at 165. In general, every arrangement (e.g. gentlemen’s agreement), contract, scheme (e.g. collective investment scheme), plan (e.g. investment plan), or understanding (e.g. Memorandum of Understanding) could be considered as an arrangement. The arrangement may also be part of another (wider) arrangement, (e.g. a master agreement such as a GMSLA (Global Master Securities Lending Agreements) or ISDA (International Swaps and Derivatives Association Master Agreement), a single arrangement, or it may be comprised of a number of arrangements. However, the scope of the hybrid mismatch rules particularly seems to focus on ‘contracts’ between two or more parties that are legally binding and enforceable in front of a Court.
but immediately targets the outcome of a particular payment. If a financial instrument is transferred, and its underlying financing or equity return is reimbursed to the transferee, this compensation will be envisaged as a ‘substitute payment’ if any of the three mentioned possible consequences is realized when compared with a direct regular payment.

Only arrangements that are treated as debt, equity, or derivative contracts under local law (category 1) and hybrid transfers (category 2) are treated as a type of financial instrument. Therefore, the focus will only be on the first two categories.

3.3.2.1 First Category: Payments Made Under a Financial Instrument

25. The hybrid financial instrument rule neutralizes mismatches caused by payments made under a financial instrument. This category is extremely broad as both the description of a ‘financial instrument’ and a ‘payment’ are very general. Besides defining a ‘financial instrument’ and a ‘payment’, the link between the payment and the financial instrument must also be considered.

26. The definition of a ‘financial instrument’ is ultimately left to each individual jurisdiction. The OECD refers to an arrangement in which one person provides money to another in consideration for a financing or equity return. All types of financial instruments – to the extent they produce a financing or equity return – could be in scope of the definition. Bonds and stock are traditional examples, however, derivative instruments and (other) synthetic securities, trackers, and structured products can also be classified as types of financial instruments. Agreements for the supply of services such as an (ordinary) lease or licensing agreement or agreements for the assumption of a non-financial risk (such as insurance) are not considered as financial instruments for the hybrid mismatch rule. Asset transfers under local law will also generally be out of scope of this first category.

The OECD encourages countries to make reasonable endeavours to adopt similar definitions of a financial instrument. However, the final determination of the type of arrangements ensconced within this definition (and, therefore, potentially subject to adjustment under the hybrid financial instrument rule) is ultimately left to the discretion of each jurisdiction. In the event of doubt, each jurisdiction should determine under local law whether and to what extent a payment is made under a financial instrument.

27. Nonetheless, recommendation 1.2a offers some type of a definition: a financial instrument, as it can be considered under this first category, is ‘any arrangement that is taxed under the rules for taxing debt, equity or derivatives under the laws of both the payee and payer jurisdictions’. However, this still incites several questions.

First of all, the text refers to a ‘taxed arrangement’. However, whereas any arrangement can provide taxable income flows, the arrangement itself is not a taxable event for income taxes. It is the income arising from an arrangement that can be submitted for income taxation. Under the arrangement, two separate value flows can be detected. On one side, value is being transferred for which, on the other side, a financing or equity return is offered. It seems that the treatment of this return should be the treatment applied to debt, equity, or derivatives under domestic tax rules.

Notes

76 Improving the tax outcome for the transferee, a deduction of the expense for the transferee without including the return of the underlying asset as taxable income or avoiding the first category throughout the transfer.

77 OECD BEPS Action 2 Final Report, supra n. 1, recommendation 1.2., (c), at 25.

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Secondly, the ‘definition’ refers to the treatment under the laws of both the payee and payer jurisdictions. Whereas a mismatch can arise for the qualification of the return for, e.g. a profit participating loan, it is also perfectly imaginable that a mismatch arises because only one party considers an arrangement to be a financial instrument. The report provides an example of an arrangement that is qualified as a finance lease according to one jurisdiction whereas the other jurisdiction qualifies this arrangement as a rental contract. Also, when only one of both of the involved jurisdictions recognizes an existing financial instrument, this jurisdiction might still apply the hybrid financial instrument rule. Therefore, the qualification of an arrangement as a ‘financial instrument’ can also come from only one jurisdiction.

28. The mismatch is caused in the tax treatment of the payment made under the financial instrument. This proves again that mismatches are typically the result of technical differences in the way jurisdictions tax the outcome of the instruments and not the differences in the way the instrument itself is legally treated by the jurisdiction.

29. The ‘payment’, being the flow that is recognized for income tax purposes, also has a broad scope. It is described as ‘any transfer of value’ which, however, is not further defined. It can only be assumed that the term ‘transfer of value’ can be considered as the acceptance of cash, cheques, and any other monetary instruments or other stores of value including interest, dividend, royalties, rents, and fees. Any present or future transfer of value will also be within the scope. It additionally includes any amount ‘capable of being’ paid such as a future or contingent obligation to make a payment and including (but not limited to) a distribution, credit, debit, and accrual of money. Hence, the accrual of a future payment obligation, even when the accrued amount does not correspond to any increase in the payment during that payment, can be considered as a payment.

30. Payments that are ‘only deemed to be made for tax purposes and that do not involve the creation of any new economic rights between the parties’ will be excluded from the mismatch. The OECD wants to avoid that regimes for which the tax deduction is not linked to any payment obligation of the issuer would come under the scope of the hybrid mismatch rule.

This is relevant for rules that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to make a payment. Such regimes that grant deemed interest deductions for equity capital are economically closer to a tax exemption or similar taxpayer-specific concessions and do not produce a mismatch in a tax outcome under the hybrid financial instrument rule.

31. Finally, the payment must be ‘made under’ the financial instrument. It is the (financing or equity) return for the previous provision of ‘money’, e.g. a dividend payment to the shareholders of the asset or an interest payment to the holders of a note can be considered as a payment made under a financial instrument. Payments that are in consideration for a release from a requirement, debt, or obligation under a financial instrument will also be considered as a

Notes

80 OECD BEPS Action 2 Final Report, supra n. 1, nr. 68, at 57.
81 Compare with OECD BEPS Action 2 Final Report, supra n. 1, nr. 423, at 132, referring to ‘money’ (including money’s worth).
82 OECD BEPS Action 2 Final Report, supra n. 1, nr. 28, at 27.
83 OECD BEPS Action 2 Final Report, supra n. 1, nr. 28, at 27.
84 OECD BEPS Action 2 Final Report, supra n. 1, Recommendation 12, at 123.
85 See OECD BEPS Action 2 Final Report, supra n. 1, Recommendation 12, at 123.
86 See OECD BEPS Action 2 Final Report, supra n. 1, Example 1.13, at 213.
87 See OECD BEPS Action 2 Final Report, supra n. 1, Recommendation 12, at 123.
88 See Cooper, supra n. 67, at 42. In this context, Cooper states that ‘the reference to payments that “involve the creation of economic rights between the parties” suggests that foreign tax credit duplication arrangements are not within the scope of the rule’.
89 OECD BEPS Action 2 Final Report, supra n. 1, nr. 11, at 18.
payment made ‘under a financial instrument’.\textsuperscript{90} However, the release itself will not constitute a payment ‘under the hybrid financial instrument rule’.\textsuperscript{91} 32. If a person pays for the transfer of an existing financial instrument (e.g. the payment to acquire a bond), this payment is a ‘payment for the disposal of the instrument’ rather than a ‘payment under a financial instrument’. However, the payment to acquire a financial instrument could still be treated as a ‘payment under a financial instrument’ in certain circumstances if the acquisition discharges (in whole or part) obligations owed under the instrument or neutralizes the economic and tax consequences for the issuer.\textsuperscript{92} 33. It can be concluded that this first category has a broad scope. Any flow of income as a return for an investment in a financial instrument can be envisaged when it occurs between related parties or under a structured arrangement. If it results in a D/NI outcome, the OECD suggests neutralizing this mismatch.

### 3.3.2.2 Second Category: Hybrid Transfers

34. A hybrid transfer is ‘an arrangement or transaction with a financial instrument’. As a consequence of the economics of the transaction and the way it is structured, the laws of different jurisdictions take opposing views (from a tax perspective) as to whether the transferor or the transferee has the ownership of the underlying asset\textsuperscript{93} or whether an additional deductible payment should be recognized. A hybrid transfer may also exploit differences between jurisdictions in attributing income from a financial asset with the effect that the same payment is treated as simultaneously received by different taxpayers who are resident in different jurisdictions.

Although it is rather ‘an arrangement to transfer a financial instrument’,\textsuperscript{94} the OECD recommendation includes this transfer agreement in the definition of a financial instrument.\textsuperscript{95} 35. Types of (potential) hybrid transfers are collateralized loan arrangements or derivative transactions in which the jurisdictions of both parties treat their resident as the owner of the loan collateral or subject matter of the derivative. The hybrid financial mismatch rule will target sale, repurchase (repo), and securities lending transactions\textsuperscript{96} for which the rights and obligations of the parties are structured in such a way that the transferor remains (finally) entitled to the financing or equity return on the financial instrument transferred under the arrangement (Figure 3).

#### Figure 3. Example: Loan Structured as a Share Repo

Under the repo, the transferor (x) conveys shares to the transferee (y) under an agreement that the transferor will acquire those shares at a future date for an agreed price (repo). According to one State (Y), the transferee it is entitled to receive the return of the underlying asset whereas, according to the other State (X), the underlying return still belongs to the transferor. The payment (the ‘manufactured dividend’) under

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**Notes**

\textsuperscript{90} This is the case, for instance, when a party receives a payment in consideration for an agreement to modify the terms of a debt instrument (e.g. lowering the interest rate of a loan) or when a party releases the counterparty from the obligation to make any further payments of principal and accrued interest. \textit{See also OECD BEPS Action 2 Final Report, supra n. 1, Example 1.18, at 226.}

\textsuperscript{91} OECD BEPS Action 2 Final Report, supra n. 1, nr. 7, at 226.

\textsuperscript{92} OECD BEPS Action 2 Final Report, supra n. 1, nr. 71, at 38 and Example 1.19, at 227.

\textsuperscript{93} Strictly speaking, the ‘ownership’ of the underlying asset refers to the person entitled to receive the (tax exempt) return of the underlying asset.

\textsuperscript{94} However, the transfer could be considered as creating an arrangement that inherently qualifies as a financial instrument. The initial transferring of the underlying financial instrument is an investment whereas the refunding of obtained benefits could be considered as the return.

\textsuperscript{95} OECD BEPS Action 2 Final Report, supra n. 1, Recommendation 1.2 (a) at 25.

\textsuperscript{96} The difference between a repo and a share lending arrangement is that the original transfer of the shares is not for a defined amount of consideration. Instead, the borrower’s obligation is to transfer the same or identical securities back to the lender at a later date.
the repo creates a deduction in the State of the transferee (Y) while the State of the transferor (X) treats the same payment as a return on the underlying shares (treated as if it were an exempt dividend). The difference in tax treatment allows the transfer to be used as part of a structured arrangement to set up a cross-border mismatch (Figure 4).97

Figure 4

Example 2: Net-Paying Repo

<table>
<thead>
<tr>
<th>State X</th>
<th>State Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transferor</td>
<td>Transferee</td>
</tr>
<tr>
<td>Share Transfer Amount X</td>
<td>Repo Amount Y = DIV</td>
</tr>
<tr>
<td>Manufactured Dividend</td>
<td></td>
</tr>
<tr>
<td>State Z</td>
<td></td>
</tr>
<tr>
<td>Dividend</td>
<td></td>
</tr>
</tbody>
</table>

This previous example can be contrasted with a net-paying repo. This will be the case if the transferee (y) does not pay the dividends received on the underlying shares to the transferor (x) (being the 'economic owner' of the shares). The transferor (x) will only acquire those shares at a future date for an agreed price that represents a 'financing return minus any distributions received on shares by the transferee during the term of the repo'. The payment that results in the D/NI outcome is the dividend on the transferred shares that is retained by the transferee under the repo. The State of the transferor (X) treats the dividend paid on the transferred shares as a deductible expense under the repo (because the repo is characterized as a loan) while the State of the transferee (Y) treats the same dividend payment as a return on the underlying shares (the lender retains the dividend as part of the agreed return on the loan and, accordingly, as exempt from taxation). The resulting mismatch could be a hybrid mismatch because it is attributable to the difference in the way both States characterize and treat the payments made under the repo.98

36. Both examples illustrate that this second category is rather caused by the qualification of the share transfer as 'borrowing versus sale and repurchase'. Nonetheless, the OECD aligns the consequences of this hybrid transfer with the treatment of financial instruments99 (and the contrasting perspective of debt versus equity).

It should be noticed, however, that a hybrid transfer can also be generated in the event that the underlying received return is not exempted from tax in the country where a payment is deducted.100 This substantiates that it does not matter whether the funds that are obtained under the transfer have been invested in assets that generate a taxable or exempt return.

37. Under local law, an asset transfer will generally not be treated as (a transaction with) a financial instrument under the hybrid financial instrument rule (as it does not provide for a financing or equity return). However, e.g. think of an interest payment for the transfer of an asset. Whereas the interest is part of the sale price being paid later and not included as separate taxable income, according to one party, the other State may recognize a separate deductible payment besides the mere price to be paid for the transfer.101 This once again reveals that treatment as a financial instrument in one jurisdiction can suffice.102

3.3.2.3 Mismatch Attributable to 'the Terms of the Instrument'

38. A payment under the first or second category only results in a hybrid mismatch when the mismatch can be attributed to 'the terms of the instrument'.103 The terms of the instrument are 'the factors or elements' that affect the (tax) treatment of the instrument itself' and, as a result, the

Notes

97 See OECD BEPS Action 2 Final Report, supra n. 1, Example 1.32, at 261.
98 See OECD BEPS Action 2 Final Report, supra n. 1, Example 1.31, at 256.
99 The same rules will apply for testing whether the mismatch in tax outcomes is a hybrid mismatch. The mismatch in outcomes must be attributed to the tax treatment of the hybrid transfer under the laws of the payer and payee jurisdictions. See OECD BEPS Action 2 Final Report, supra n. 1, at 28.
100 OECD BEPS Action 2 Final Report, supra n. 1, Examples 1.33, at 266. This illustrates a share lending for which a manufactured dividend is paid to the lender. Although the country of the borrower taxes the underlying dividend, the reimbursing of this dividend to the lender is still deductible in the borrower's country and not taxable in the State of the lender.
101 OECD BEPS Action 2 Final Report, supra n. 1, Example 1.27, at 246 provides an illustration of these types of transactions.
102 See Cooper, supra n. 67, at 340.
103 This is unlike the category of the substitute payments which applies to any type of D/NI outcome regardless of how it arises.
tax consequences of a payment under the financial instrument. Knowing whether a mismatch is attributable to the terms of the instrument requires a counterfactual test that questions whether the terms of the instrument were sufficient to bring about the mismatch in tax outcomes. This can be done by “contrasting the parties” actual tax treatment with what it would have been if the instrument had been held directly, and both the payer and payee were ordinary taxpayers that computed their income and expenditure in accordance with the ordinary rules applicable to taxpayers of the same type. If the same mismatch would have arisen had the instrument been directly entered into by a taxpayer of ordinary status, then the mismatch will be attributable to the terms of the instrument itself rather than the status of the taxpayer or the context in which the instrument is held. The OECD BEPS Action 2 Report provides different examples of mismatches in tax outcome that are either attributable to the terms of the instrument, or (solely) attributable to other terms.

39. The fact that a mismatch in tax outcome is also attributable to ‘other factors’ does not prevent the application of the hybrid financial instrument rule. Only differences that are ‘solely’ attributable to the status of the taxpayer or the circumstances in which the instrument is held will not result in a hybrid mismatch. For example, a mismatch in tax treatment that arises in respect of a cross-border payment made to a taxpayer in a pure territorial tax regime will not be captured by the hybrid financial instrument rule. The mismatch in tax outcomes is solely attributable to the nature of the payer and not to the terms of the instrument itself. However, the mismatch will be caught by the mismatch rule if the exemption on foreign source income is only applicable to a particular category of income (i.e. dividends). The tax exemption then not only depends on the source of the payment itself, but also the character of the instrument under the laws of the payee jurisdiction (and, accordingly, the terms of the instrument) is decisive. In the latter case, the payment could still fall within the scope of the hybrid financial instrument rule.

40. It is the taxpayer who will have to prove that a mismatch in tax outcome is ‘solely’ attributable to ‘other’ factors or elements.

3.3.2.4 Regulatory Capital Instruments

41. The effect of the hybrid financial instrument rule for regulatory capital instruments is particularly relevant for the financial industry. This reason is found in the regulatory regimes governing the financial sector. Some of the hybrid financial instruments are specifically designed to satisfy these regulatory requirements. For example, in the wake of the financial crisis, the Basel III regulatory framework began requiring banks to issue (additional) capital instruments in order to replenish their regulatory capital. The increase of

Notes

104 OECD BEPS Action 2 Final Report, supra n. 1, nr. 51, 58 and 95, at 32, 35 and 42.
105 For example, Company x provides Company y with a subordinated loan. Both companies are resident in Country X. Due to differences in the way the interest
106 Basel III: International Regulatory Framework for Banks
107 See also supra n. 1, nr. 51 and seq., at 41 ff.
108 40. It is the taxpayer who will have to prove that a mismatch in tax outcome is ‘solely’ attributable to ‘other’ factors or elements.
109 The increase of
the capital levels under Basel III definitely impacts the use of hybrid financial instruments.

The total banks’ regulatory capital consists of Tier-1 capital that includes common equity Tier-1 (CET1) and additional Tier 1 as well as Tier-2 capital (such as convertible capital instruments or bail-in bonds). CET1 – capital is essentially equity capital and cannot qualify as an instrument having a debt character (allowing deduction of payments made) for tax purposes. However, the tax classification (debt or equity) of additional Tier 1 (AT1) and Tier 2 (AT2) capital is less clear. Financial institutions must fulfil their prudential obligations through these capital instruments that have both debt and equity-like features. Qualified as debt, they generate regular remuneration payments but being subordinated, perpetual, and automatically convertible to ordinary shares in periods of stress, they also resemble equity. This may increase the likelihood of a hybrid mismatch in tax outcomes.

42. The implementation of the OECD recommendations on hybrid financial instruments could have the effect of discouraging financial institutions to raise AT1 and AT2 capital, although the primary reason for issuing such capital is to manage solvency and/or financial ratings. This is not used as a tool for tax-planning. The issuance of any AT1 or other regulatory capital also has to be approved by the issuing bank’s supervisory authority.

43. The relevance of regulatory capital instruments was pointed out in the Action 2 Discussion Draft on neutralizing the effects of hybrid mismatch arrangements. According to the OECD, it is assumed that AT1-instruments that are issued directly to the market are unlikely to be captured by either a related-party hybrid mismatch rule or a more widely drafted rule that contains a specific carve-out for ‘widespread’ or ‘traded’ instruments. However, countries are left to their own discretion in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intra-group hybrid regulatory capital. Whether one country decides to not apply the rules to neutralize a hybrid mismatch in respect of a particular hybrid regulatory capital instrument does not affect another country’s policy choice to apply the rules regarding the particular instrument.

3.4 Mismatch in Tax Outcome: DI/NI Mismatch

44. A mismatch in tax outcome in respect of a payment made under a financial instrument will only arise if the payment is ‘deductible’ under the laws of one jurisdiction, but no corresponding income is included in the tax base of another State. This will

Notes

110 A specific example of additional Tier-2 capital are the Contingent convertible instruments (CoCos). CoCos are fixed-income instruments that are convertible into equity if a trigger event occurs.


113 OECD, Neutralising the Effects of Hybrid mismatch Arrangements, supra n. 21, at 12.

114 OECD BEPS Action 2 Final Report, supra n. 1, at 12. See also OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, supra n. 21, at 12.

115 In most scenarios, a payment under a financial instrument will be deductible in the payer jurisdiction (which can include any jurisdiction where the payee is a taxpayer) when the payment is qualified as an interest. However, ‘deductible payments’ under a financial instrument are not limited to interest. Also, interest discount and redemption premiums, facilities and lending fees, and payments under derivative contracts can generate deductible payments to the extent they are treated as separate items of deductible expenditure. Therefore, a payment will be deductible each time it causes an equivalent tax relief. This does not cover depreciations or amortizations. See OECD BEPS Action 2 Final Report, supra n. 1, at 51.

116 So OECD BEPS Action 2 Final Report, supra n. 1, nr. 42, at 10. A deductible payment (in the payer jurisdiction) will create a mismatch wherever the payer jurisdiction subjects the payment to taxation at a rate e.g. less than the full marginal rate imposed on ordinary income regardless of the form in which such tax relief is provided: Mechanisms for securing tax relief in the payer jurisdiction (by exclusion or through exemption, rate reduction, credit, or any other method) should not generally impact the final outcome under the hybrid financial instrument rule. However, certain countries tax various types of income at different rates. For example, business or employment income may be taxed at a different rate than investment income. These differences should be taken into account in determining whether the payment has been subject to tax at the taxpayer’s full marginal rate.

117 So OECD BEPS Action 2 Final Report, supra n. 1, nr. 32, at 28. The OECD BEPS Action 2 Report refers to ‘included in the ordinary income’. Ordinary income are those categories of income that are subject to tax at the taxpayer’s full marginal rate. These categories do not benefit from any exemption, exclusion, credit, or other tax relief i.e. applicable to particular types of payments (such as indirect credits for underlying tax on the income of the payer). A payment will be treated as being included in ordinary income to the extent that, after a proper determination of the character and treatment of the payment under the laws of the payer jurisdiction, the payment is required to be incorporated as ordinary income into a calculation of the payer’s taxable income. A payment of ordinary income under a financial instrument will generally include interest, dividends, and other investment returns that are subject to tax at the payer’s full marginal rate. Income is considered subject to tax at the taxpayer’s full marginal rate, however, notwithstanding that the tax on the inclusion is reduced by a credit or other equivalent tax relief granted by the payer jurisdiction for withholding tax or other taxes imposed by the source jurisdiction on the payment itself.
result in a (direct or indirect) D/N outcome. Payments that give rise to deduction/deduction (D/D) outcomes are not covered by the hybrid financial instrument rule.

45. The mismatch in tax outcome will be determined by comparing the laws of each jurisdiction regarding the tax treatment of a payment under a financial instrument. In analysing the application of the local law, the ‘actual’ tax treatment (as the taxpayer knows its own tax treatment) of the payment in the taxpayers’ jurisdiction must be compared with its ‘expected tax treatment’ in the counterparty jurisdiction. The character, amount, and timing of payments under a financial instrument in both the payer and payee jurisdiction are relevant elements to determine whether a payment gives rise to a mismatch. Although it is necessary to know the identity of the counterparty and the applicable tax rules of each jurisdiction, it is not required to know the counterparty’s tax status to determine whether a payment generates a hybrid mismatch.

46. The mismatch in tax outcome can be partial. This occurs when (1) a payment is only partially treated as deductible under the laws of one jurisdiction and not included in ordinary income by any other jurisdiction or (2) a payment is treated as being deductible under the laws of one jurisdiction, but only a part of the payment is excluded from ordinary income by any other jurisdiction. The fact that company A is a trader and may include the payment in ordinary income as proceeds from the disposal of trading assets will not impact on the determination of whether the terms of the instrument and the payment made under it are expected to give rise to a D/N outcome.

47. What happens if the mismatch in a tax outcome is the result of timing differences? Timing differences, as such, will not be considered to give rise to a hybrid mismatch. This could be relevant when jurisdictions use different tax accounting periods and have different rules for recognizing when items of income or expenditure have been received or incurred (e.g. the payer jurisdiction adopts an accrual-based taxation and the payee jurisdiction follows a cash-based taxation). A deductible payment is not treated as creating a mismatch if it is included by the payer in ordinary income in an accounting period that commences ‘within twelve months of the end of the payer’s accounting period’.

Even if the payment does not meet the requirements of this safe harbour of twelve months, the payer is still entitled to deduct the payment if the payee, to the satisfaction of the tax administration, can be expected to include the payment in ordinary income ‘within a reasonable period of time’. The determination of whether this payment will be made within a reasonable period of time should be based on the time period that might be expected to be agreed between unrelated parties acting at arm’s length.

Notes

119 These are payments that are deductible under the rules of the payer jurisdiction and that are set-off by the payer against a deduction under a hybrid mismatch arrangement.

120 This rather concerns payments made by hybrid entities that are not being dealt with in this article.

121 In general, it will not be necessary for the taxpayer or tax administration to know precisely how the payments under a financial instrument have actually been taken into account in the calculation of the counterparty’s taxable income in order to apply the rule. See OECD BEPS Action 2 Final Report, supra n. 1, nr. 85, at 40. This could result in double taxation. See OECD BEPS Action 2 Final Report, supra n. 1, Example 1.29, at 251. The fact that a payer acts as trader and may include by the payment in ordinary income as proceeds from the disposal of trading assets will not impact on the determination of whether the terms of the instrument and the payments made under it are expected to give rise to a D/N outcome.

122 This is the amount i.e. capable of being paid.

123 Nonetheless, the hybrid financial instrument rule does not generally apply to differences in the timing of the recognition of payments under a financial instrument. See margin nr. 47.

124 OECD BEPS Action 2 Final Report, supra n. 1, nr. 53, at 33. Differences in tax outcomes that are ‘solely’ attributable to differences in the value ascribed to a payment (including through the application of transfer pricing) do not fall within the scope of the hybrid mismatch rule). Therefore, a mismatch does not arise simply because of differences resulting from converting foreign exchange into local or functional currency. Gains and losses that result from converting foreign exchange into local or functional currency are attributable to the way jurisdictions measure the value of money rather than the value of the payment itself. See also OECD BEPS Action 2 Final Report, supra n. 1, Example 1.15 and 1.16, at 219–222.

125 If the counterparty is transparent or has a taxable presence in more than one jurisdiction, it may be necessary to examine the laws of more than one jurisdiction to determine whether the payment will give rise to a mismatch.

126 See OECD BEPS Action 2 Final Report, supra n. 1, nr. 53, at 28 and nr. 84–86, at 40–41. See also OECD BEPS Action 2 Final Report, supra n. 1, Example 1.29, at 251: ‘The fact that company A is a trader and may include the payment in ordinary income as proceeds from the disposal of trading assets will not impact on the determination of whether the terms of the instrument and the payments made under it are expected to give rise to a D/N outcome.’

127 OECD BEPS Action 2 Final Report, supra n. 1, nr. 10, at 17.

128 OECD BEPS Action 2 Final Report, supra n. 1, nr. 85, at 69. The burden of proof however remains with the taxpayer.

129 See also Santos, supra n. 41, at 510.

130 See OECD BEPS Action 2 Final Report, supra n. 1, nr. 57, at 34. According to the OECD, ‘A payment can expected to be included in ordinary income where there was a reasonable expectation at the time the instrument was issued that the payment would be made and that such payment would be included in ordinary income by the payee at the time it was paid. If the terms of the instrument and other facts and circumstances indicate that the parties placed little commercial significance on whether payment would be made, or if the terms of the instrument are structured in such a way that such payment, when it is made, will not be treated as giving rise to ordinary income in the hands of the payer, then the payment cannot be said to be reasonably expected to be included in income.’

131 OECD BEPS Action 2 Final Report, supra n. 1, nr. 56, at 54.
The given interpretation is rather subjective and could differ between jurisdictions. Unfortunately, the OECD BEPS Action 2 Report does not provide additional information. It only mentions that the terms of the instrument, the circumstances in which it is held, and the commercial objectives of the parties, taking into account the nature of the accrual and any contingencies or other commercial factors affecting payment, are factors that will be relevant for determining the reasonable period of time.  

For example, a secured loan that is used to finance infrastructure investments may be expected to have longer payment terms compared to an unsecured loan that is utilized to fund working capital. It is also not clear when the ‘reasonable period of time’ for income inclusion begins. It seems reasonable to assume that this period commences after the payment under the hybrid financial instrument (and, for instance, the timing of a deduction for tax purposes). However, it would be beneficial to have additional guidance on the burden of proof requested from a taxpayer in order to demonstrate that a relevant payment is or will be included in the taxable income of the recipient within a reasonable period of time; a certificate of the tax authorities of the recipient’s State could deliver the requested proof.

3.5 Neutralizing the Hybrid Financial Mismatch

3.5.1 Particular Measures for the Tax Treatment of Financial Instruments

48. A payment under a hybrid financial instrument will not be treated as giving rise to a D/NI outcome if the mismatch is neutralized in the payee’s jurisdiction. The tax treatment of the payment could be brought into accordance with the tax outcomes that will generally apply to similar instruments in a domestic context in the payee’s jurisdiction. Specific rules of this nature will include any rule in that jurisdiction, consistent with Recommendation 2.1. of the OECD BEPS Action 2 Report, that limit the availability of a dividend exemption or equivalent tax relief for payments treated as a deductible payment by the payer State. Equally, jurisdictions should consider adopting similar restrictions for other types of dividend relief that are granted to relieve economic double taxation on underlying profits.

49. The administration of the payee jurisdiction will examine the instrument under which the payment was made and whether the issuer of that instrument was entitled to a deduction. Third States’ effects do not appear to be taken into consideration. If a dividend triggers a deduction for a separate taxpayer in any other (third) jurisdiction – other than the jurisdiction of the issuer – (e.g. due to the existence of a hybrid transfer), this will generally not lead to a denial of the dividend exemption in the payee’s jurisdiction.

This can be illustrated with the payment of a manufactured dividend on shares having been subject to a repo. The first example that should be referred to is mentioned in margin nr. 35. It may be the case that the State of the transferor (State X) has implemented rules consistent with recommendation 2.1 that would remove the benefit of a dividend exemption when the payment is deductible for tax purposes. In this case, however, recommendation 2.1 will generally not apply as it only considers the tax treatment of the payment under the laws of the State of the issuer (State Z) and whether the issuer was entitled to a deduction for such payment. In this example, the payment triggers a deduction for the repo counterparty in a third jurisdiction (State Y). The payment, however, is not deductible for the issuer of the shares (State Z). The recommended changes to domestic law in recommendation 2.1, therefore, are not expected to restrict the holder’s entitlement to an exemption on the dividend.

50. The OECD BEPS Action 2 Report also provides a specific measure in the event that a hybrid transfer allows parties to claim withholding tax credits on payments that have the effect of

Notes

131 Ibid., nr. 58, at 34.
132 In this line, see also Santos, supra n. 41, at 510.
133 This can be compared with the certificate of residence i.e. required to obtain a reduction/an exemption of a foreign withholding tax based on a double tax convention.
135 In order to prevent duplication of tax credits under a hybrid transfer, the Action 2 Report also recommends any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer to restrict the benefit of such relief in proportion to the net taxable income of the taxpayer under the arrangement. See OECD BEPS Action 2 Final Report, supra n. 1, recommendation 2.2. at 45-46.
lowering their effective tax burden under the instrument. As mentioned in margin nr. 54, a hybrid transfer (also) targets differences between two countries’ rules for attributing income from an asset with the result that the same payment is treated as simultaneously received by different taxpayers who are resident in different jurisdictions. For example, a taxpayer (Company x) borrows securities under an arrangement that generally includes the requirement to make ‘manufactured payments’ to the lender (Company y) of any amounts paid on the underlying securities during the period of the loan. Companies x and y are treated as receiving an interest payment with the result that both parties claim a withholding tax credit on the payment made under the hybrid transfer. In order to prevent the duplication of tax credits under a hybrid transfer, the OECD recommends limiting the ability of a taxpayer to claim relief from foreign withholding tax on instruments that are held subject to a hybrid transfer. This restriction of the benefit of such relief should be in proportion to the net taxable income of the taxpayer under the arrangement.\textsuperscript{136}

### 3.5.2 Two-tiered Approach: Restricting the Deduction of a Payment or Taxing the Income

51. If the mismatch in tax outcome is not neutralized by a specific rule under domestic law, a further two-tiered\textsuperscript{137} approach is suggested. The ‘primary response’ is to restrict the deduction of the payment for income tax purposes. However, if the payer jurisdiction does not restrict the deduction of the payment (or does not introduce the anti-hybrid rule into its domestic tax law), the payee jurisdiction should apply a secondary measure. As a so-called ‘defensive rule’ to ensure the effectiveness of the anti-hybrid rule, the payment is taxed at the level of the beneficiary.\textsuperscript{138}

52. Initially, the OECD requested the development of instruments to put an end to or neutralize the effects of hybrid mismatch arrangements and arbitrage.\textsuperscript{139} However, based on the design of earlier drafts of the hybrid rules, the OECD concluded that domestic law rules linking the tax treatment of an instrument or transfer to its tax treatment in another country had a significant potential as a tool to address hybrid mismatch arrangements.\textsuperscript{140} The finally proposed linking rules no longer search for harmonization in qualification or well-balanced solutions but only mitigate double non-taxation.\textsuperscript{141} They do not neutralize the effect of hybrid mismatches in general and, therefore, leave the case of double taxation unresolved.

53. The underlying principle simply aligns the tax treatment (not qualification) of payments under a financial instrument in both States: a payer cannot claim a deduction for a financing expense unless the payment is included in ordinary income in the payee jurisdiction. This outcome is achieved by adjusting the deductions that are allowed under the laws of the payer jurisdiction or including the income in the payee jurisdiction, as appropriate, in order to ensure that the abstract aggregate tax treatment of the arrangement is the same regardless of the form of instrument used or whether the adjustment is made in the payee or payer jurisdiction. As the rules apply automatically, the order prevents that more than one country applies correctives to the same arrangement. In this way, turning a D/NI-situation into an ND/I-situation (non-deduction and inclusion) is avoided. The order of corrective measures is formulated in abstract and does not consider whether or to what extent the person subject to the adjustment has benefitted from the mismatch.

54. Although a full harmonization is not being searched for, the linking rules make a domestic tax treatment dependent on a tax treatment in the counterparty. This complicates the application of

### Notes

\textsuperscript{136} OECD BEPS Action 2 Final Report, supra n. 1, Recommendation 2.2. nrs. 112–113, at 47.

\textsuperscript{137} As not all States will want or will be able to implement such rules, they should implement a ‘primary rule’ to address these situations but should also be prepared to implement a ‘defensive (secondary) rule’ to apply in situations in which the other State i.e. party to a transaction has not implemented the primary rule in its domestic law.

\textsuperscript{138} OECD BEPS Action 2 Final Report, supra n. 1, nr. 7 at 17.

\textsuperscript{139} OECD, Action Plan on Base Erosion and Profit Shifting 13 (OECD Publishing, 19 July 2015), http://www.oecd.orgctp/OECDActionPlan.pdf (accessed 14 Oct. 2019). The harmonization of domestic tax systems would obviously be the most effective way to eliminate mismatches at their source. However, considering current circumstances, this appears to be a difficult option. For example, in 2011, the European Commission proposed to adopt a harmonized corporate tax base for European multinational enterprises in combination with a tax consolidation regime that was referred to as the common consolidated corporate tax base (CCCTB). As this proposal proved to be too ambitious, the Commission proposed to relaunch a new version of the CCCTB in 2016. However, it was still difficult to foresee a unanimous agreement being reached in the Council. On 6 June 2019, the Council published its latest Presidency compromise on the file. Unfortunately, even if the current proposal of the CCCTB were implemented, mismatches are likely to persist in the interaction between the framework of the common base and national or third-country corporate tax systems.

\textsuperscript{139} OECD, Hybrid Mismatch Arrangements, supra n. 1.

domestic tax rules. However, considering the unilateral interpretation of the provisions, disagreements may feasibly still cause further tax burdens. As such, the qualification of the payment as being made under a financial instrument is unilaterally determined. If, e.g. the payee jurisdiction does not qualify a payment as such, the primary rule will still apply in the payer jurisdiction (as far as the payment would be expected to generate a mismatch in tax outcomes). However, conflicts can arise when a taxpayer is unaware of the tax treatment of payments under a financial instrument for the calculation of the counterparty’s taxable income. If a deduction of a payment is denied, whereas this income is ultimately taxed at the level of the beneficiary following the elapse of the ‘reasonable period of time’, double taxation still arises.

55. An additional difficulty is that the instrumental rules consider one payment as a whole. As stated, partial mismatches can also appear but are not envisaged. It is not unrealistic that a financial instrument consists of various elements with multiple underlying cash flows that result in one effective payment. The linking rules are based on a singular cash flow and make no distinction between multiple payments made under a hybrid financial instrument. In this context, it will be difficult to (additionally) partially deny the deduction of the payment in the payer jurisdiction or to tax parts of the payment in the payee jurisdiction.

56. The hybrid financial instrument mismatch rules can be easily circumvented by importing the mismatch outcome to a third State. This will be the case when different structures are used and layered on top of one another to shift the D/NI outcome from jurisdiction to jurisdiction. Therefore, this rather direct set of rules is further complemented in the case of a third State that is financing the creation of the hybrid payment between two States that have not provided for any of the recommended rules. Although the imported mismatch rule is not the focus of this article, it is relevant to understand how the rule operates and prevents taxpayers from entering arrangements that shift the effect of an offshore hybrid mismatch into the domestic jurisdiction through the use of a non-hybrid instrument such as an ordinary loan.

An example could be a profit participating loan that is treated as a loan from the borrower’s domestic law perspective (b) and as equity from the lender’s domestic law perspective (a). Company b (Country B) uses the borrowed funds received from Lender a (Country A) to grant a (regular) loan to another operational group Company c (a resident in Country C). Company c is allowed to deduct the interest payments on its loan from Company b. Although Company b incorporates the interest payments from Company c into its taxable income, they are offset by the deduction of interest payments to Company a. This latter deduction however, is not reflected by an inclusion of the interest income in Country A as, according to its domestic law, the payment is considered to qualify as equity. The final result for States A, B, and C would be an interest deduction (from a regular payment) in State C without any net inclusion of this interest payment in any other State.

Country B would first have to refuse the deduction of b’s interest payments to Company a and thereby increase the tax income of b. If this were not applied, Country A would have to raise its tax income by including the received payment in the taxable income of Company a. If neither Country A nor Country B raise their taxable income, Country C is considered to have imported the mismatch and should deny the deduction of the interest payment supported by Company c, to the extent that this
payment has been set-off against a hybrid mismatch arrangement. 148

3.6 General Conclusions Concerning the OECD Initiative

57. The first section of this article illustrated how the hybrid financial instrument rule under the OECD BEPS Action 2 Report provides a two-tiered approach to counter double non-taxation resulting from the deduction of a payment from a tax base without the corresponding inclusion of this income in another tax base. The rule applies to ‘payments’ under a financial instrument between ‘related parties’ or under a ‘structured arrangement’.

The measure definitely provides inspiration for national and international policy making against so-called ‘aggressive tax planning’. However, both the test of whether a financial instrument is a hybrid arrangement and the proposed linking rules leave many uncertainties and could result in odd outcomes. The two-tiered approach largely depends upon cooperation between the participating jurisdictions and will certainly increase the complexity of unilateral domestic tax systems. Nonetheless, since its outcome, there has been general support for the implementation of the OECD hybrid financial instrument rule. For example, at the EU level, this rule was progressively introduced in the ATAD as will be further illustrated.

4 HYBRID FINANCIAL INSTRUMENTS UNDER THE ATAD

4.1 General Remarks

58. After having elaborated the OECD initiative, the second section of this article will focus on the implementation of the hybrid financial instrument rule in the European Union by means of the ATAD. 59. Contrary to the Commission’s initial proposal, the ATAD I149 only covered intra-EU situations involving hybrid entities and financial instruments. Therefore, the ECOFIN-council requested already in its meeting of 12 July 2016 that the Commission ‘put forward a proposal by October 2016 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, with a view to reach an agreement by the end of 2016’. 151

The result, the ATAD II,152 amending the ATAD I, draws upon the recommendations of the OECD BEPS Action 2 Report. It extends the scope and operation of the hybrid mismatch rule also addressing hybrid mismatches with non-EU Member States and providing operative rules for other additional mismatches. 153 The Directive substantially amends the existing definitions bringing them in accordance with the BEPS Action 2 Report. Whereas, under the ATAD I, the implementation of the hybrid financial instrument rule had been foreseen by 31 December 2018, it extends the delay by one year (with a derogation for the reverse hybrid mismatch rule which must apply as from 1 January 2022). 154

60. The ATAD II also explicitly refers to the OECD BEPS Action 2 Report as a source of illustration/interpretation to the extent these recommendations are consistent with the provisions of the ATAD and EU Law. 155 Therefore, this part analyses similarities and (potential) differences between the ATAD and the OECD BEPS Action 2 Report and takes into account comments made in the previous part.

4.2 The Hybrid Financial Instrument Rule

61. In very broad terms, the hybrid financial instrument rule of Article 9, §2 ATAD follows

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148 See OECD BEPS Action 2 Final Report, supra n. 1, recommendation 8, at 83 ff.
149 This proposal opted to eliminate the cause of a hybrid mismatch aligning the different classifications of a financial instrument. The double non-taxation was avoided through a ‘residence follows source’ approach with respect to the characterization of the financial instrument (the underlying problem). However, this obligated qualification has been removed from the ATAD. The final solution that was provided only addresses the differences in (direct) D/NI outcome of the financial instruments thereby disregarding situations of double taxation.
150 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, supra n. 12.
151 See EU Council, supra n. 13, at 497.
153 Including hybrid permanent establishment mismatches, imported mismatches, reverse hybrid mismatches, tax residency mismatches, and hybrid transfers.
154 Art. 11, §5a ATAD.
155 See preamble nr. 27 ATAD II.
the so-called ‘linking rules’ of the OECD-approach. In a ‘deduction without inclusion’ outcome, the deduction shall be denied in the Member State (as far as the payment is sourced in a Member State) being the payer jurisdiction. If the deduction is not denied in the payer jurisdiction, the amount of the payment causing the mismatch outcome shall be included in the taxable income of the Member State being the payee jurisdiction.

This must be further combined with Article 4a P/S Directive that obligates a Member State to refrain from taxing a parent company on distributed profits ‘to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary’. Although initially developed from a different angle, this already reveals a partial integration of OECD recommendation 2 that precedes the linking rules.156

62. Article 9, §3 ATAD addresses imported mismatches157 in that an EU Member State should deny payment deductions when they are used to finance the creation of a hybrid mismatch in two other States unless one of them has made equivalent adjustments. As the first part did not particularly focus in detail on ‘imported mismatches’, this §3 will not be analysed in detail. However, in contrast with the OECD initiative, the ATAD is binding for EU-Member States. This raises the question as to whether the defensive measure (or the imported mismatch rule) applies if another Member State does not fulfil its obligation to act in primary (or secondary) order. Being analogue for both subsequent actions, this question will be dealt with in margin nr. 97 after the comparison of the European hybrid financial instrument rule with the OECD recommendations.

4.3 Scope of the Rule

63. The EU rule applies to ‘a payment under a financial instrument’ that is qualified as a ‘hybrid mismatch’ between ‘associated enterprises’ or entered into as part of a ‘structured arrangement’.158

4.3.1 Personal Scope

64. Whereas the OECD recommendation remained relatively vague about its personal scope,159 the ATAD is directed towards taxpayers who are subject to corporate income tax160 in one or more Member States. This includes permanent establishments in one or more Member States of entities resident for tax purposes in a third country.161 A further definition of ‘taxpayer’ and ‘corporate tax’, however, was left for domestic interpretation when Member States transpose the Directive.162

With regard to the hybrid financial instruments mismatch rule, the two broad categories of the BEPS Action 2 Report, i.e. related parties and structured arrangements, are being repeated. However, whereas the notion of a ‘structured arrangement’ is copied, the ATAD refers to ‘associated enterprises’ instead of ‘related parties’. Finally, an exclusion for financial traders has been put more prominently in the forefront.

4.3.1.1 Associated Enterprises Instead of Related Parties

65. ‘Related parties’ has been replaced by ‘associated enterprises’, a more generalized concept of the ATAD. For these general purposes ‘associated’ refers to:

1. an entity in which the taxpayer directly or indirectly holds participation in terms of voting rights or capital ownership of 25% or more or is entitled to receive 25% or more of the profits of that entity; and

Notes

156 See margin nrs. 48–49.
157 See margin nr. 56.
158 Art. 2, §9 and, in particular, Art. 2, § 9, al. 2, c) ATAD.
159 See margin nr. 15.
160 See Preamble nr. 4 ATAD I and Art. 1, §1 ATAD.
161 According to Fibbe & Stevens, hybrid mismatches with individuals are, as such, disregarded. See G. Fibbe & T. Stevens, Hybrid Mismatches Under the ATAD I and II, 26(3) EC Tax Rev. 166 (2017). However, structures with individuals involved are not necessarily out of scope. For example, imagine Individual x (a resident of State X) holding a capital ownership of 25% in Company y (a resident in State Y). Company y makes an interest payment under a hybrid financial instrument to Individual x. Company y is entitled to a deduction for the interest payments whereas the payment is not treated as ordinary income in State X. As the mismatch is determined to be a hybrid mismatch (involving a taxpayer), it is our opinion that State Y should still apply the hybrid mismatch rule and deny Company y a deduction for the payment made under the hybrid financial instrument to the extent of that mismatch.
162 See Preamble nr. 4 ATAD I. Considering that it would result in the need to cover a broader range of national taxes, it is not desirable to extend the scope of this directive to types of entities that are not subject to corporate income tax in a Member State (e.g. transparent entities). In this context, the question was raised as to whether reverse hybrid entities would fall within the scope. This issue was solved under the ATAD II by introducing separate hybrid mismatch rules for reverse hybrid entities. See Art. 1, §2 and Art. 5a ATAD.
(2) an individual or entity that directly or indirectly holds participation in terms of voting rights or capital ownership in a taxpayer of 25% or more or is entitled to receive 25% or more of the profits of the taxpayer. All directly or indirectly interconnected entities are regarded as associated.\textsuperscript{163}

66. The Directive does not clarify what is meant with the terms ‘voting rights’ or ‘capital ownership’. Considering preamble nr. 27, we refer to the OECD BEPS Action 2 Report. The term ‘voting rights’ should hence be considered as ‘the right to participate in any decision-making concerning a distribution, a change to the constitution or the appointment of a director’.\textsuperscript{164} Instead of ‘capital ownership’, however, the OECD BEPS Action 2 Report refers to ‘equity interest’, meaning ‘an entitlement to an equity return’. This rather seems to be linked with the third option of being entitled to receive the profits of the entity. ‘Capital ownership’, therefore, is not further defined.

However, both concepts (voting rights and capital ownership) also appear in Article 3 P/S- Directive and Article 3, b) I/R-Directive.\textsuperscript{165} A common understanding for all of these European direct tax directives would also enhance tax certainty. Nonetheless, at present, these concepts do not appear to invoke particular questions.

As a taxpayer’s degree of ownership can vary over time, it is our opinion that the participation threshold should be met at the time of the payment (and not, for instance, at the end of the year).\textsuperscript{67} In particular with regard to hybrid mismatches, the specified threshold for ‘associated enterprises’ is further adapted. Except for hybrid financial instruments and deemed payments, the 25% threshold is replaced by a 50% requirement which brings the threshold in accordance with the OECD proposal.\textsuperscript{166} Additionally, the term ‘associated enterprises’ also means (1) entities that are part of a same consolidated group for financial accounting purposes\textsuperscript{167} and (2) enterprises that have ‘significant influence’ in the management of the taxpayer (or in which a taxpayer has significant influence in the management).\textsuperscript{168}

68. The purpose of the (extended version) of the term ‘related parties’ was to bring the definition in line with the concept of ‘control group’ of the OECD BEPS Action 2 Report. However, differences still exist. The definition of ‘related parties’ does not refer to the term ‘associated enterprises’ under Article 9 of the OECD Model Tax Convention nor is the concept of ‘effective control’ used.\textsuperscript{169} Instead, Article 2, §4, al. 3, c) ATAD refers to enterprises in which the taxpayer has a ‘significant influence’ in the management (and, conversely, an enterprise that has a ‘significant influence’ in the management of the taxpayer). Such ‘significant influence’ seems less compelling compared to ‘effective control’ as is required under the OECD BEPS Action 2.\textsuperscript{170} Moreover, this ‘significant influence’ test is not a new concept. It is also used in the international financial reporting standards to determine whether an entity should be included in consolidated financial statements.\textsuperscript{171}

69. Article 2, §4, al. 3, b) ATAD also provides an ‘acting-in-concert’ test. The (voting or capital) rights of persons acting together in respect of these rights are aggregated for the purposes of applying the required thresholds to be ‘related’. As mentioned in margin nr. 17, this measure preserves the effectiveness of the rule

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163 Art. 2, §4 first part ATAD.
164 See OECD BEPS Action 2 Final Report, supra n. 1, Recommendation 12, at 123.
165 Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation i.e. applicable to interest and royalty payments made between associated co-
166 See margin nr. 16.
167 According to IFRS 10, if one or more of the elements of control are not present, it will be necessary to determine the nature of the investor’s relationship with the investee. An investor can have power over an investee even if other entities have existing rights that provide them the current ability to participate in the direction of the relevant activities. e.g., when another entity has significant influence (IFRS 10, 12–13). See also IAS 28, §3 according to which significant influence is ‘the power to participate in the financial and operating policy decisions of the investee, but it is not control or joint control over these policies. When a fund manager has significant influence, the investment fund is an associate of the fund manager’. 
and avoids tax planning schemes. It will prevent taxpayers from circumventing the hybrid mismatch rule by entering into arrangements that would allow them to act together (or under the direction of a single controlling mind). However, unlike the OECD BEPS Action 2 Report, no particular definition or presumption of what is considered to be ‘acting together’ is provided. Whereas the Report also refers to ‘equity interests’, the ATAD only mentions voting and capital rights. In addition, it is unclear whether the acting-together test will be effective if one or more taxpayers are acting together from third countries. As the event might occur outside the European Union, it will be difficult to perform a correct analysis.

172 Additional information regarding the acting-together test and the persons within the scope of the measure, therefore, would certainly be welcome.

70. In conclusion, although the purpose was to echo the OECD concept, the exact same wording has not been used. This could lead to a slightly different understanding of the envisaged persons.

4.3.1.2 Party to a Structured Arrangement

71. The hybrid financial instrument mismatch rule also applies to hybrid mismatches resulting from a structured arrangement involving a taxpayer. In accordance with the OECD BEPS Action 2 Report, Article 2, §11 ATAD defines a ‘structured arrangement’ as ‘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 mismatch’.

As the ATAD does not provide any additional guidance, we refer to our analysis of the provisions of the OECD BEPS Action 2 Report in order to understand the meaning of this concept.174

4.3.1.3 Exclusion for Financial Traders

72. The hybrid financial instrument mismatch rule is not applicable when a payment is made by a financial trader175 under an on-market hybrid transfer176 provided that the payer jurisdiction requires the financial trader to include as taxable income all amounts received in relation to the transferred financial instrument.177 This means that the carve-out will only apply if the following cumulative conditions are fulfilled: (1) the payment is made by a financial trader in the ordinary course of business, (2) under a hybrid transfer, (3) not as part of a structured arrangement, and (4) the financial trader shall include as income all amounts received in relationship to the transferred financial instrument. The ‘payment’ representing the underlying return on a transferred financial instrument shall, in that case, not create a hybrid mismatch; neither the payer nor the payee will have to apply the linking rules.178 The effects of the carve-out for the payee are, as such, contingent upon the fulfillment of these four conditions by the financial trader in the payer jurisdiction.

73. The rationale behind this carve-out is based on the OECD recommendations that the hybrid financial instrument rule should not affect the ability of a trader to take the full amount that is payable under the asset transfer agreement into account when calculating the gain or loss on the disposal of the asset. A trader that purchases and sells securities will treat the net profit or loss on each trade as included in taxable income (or deductible for tax purposes, as the case may be) regardless of the tax treatment of the underlying

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172 See Santos, supra n. 41, at 507.

173 OECD BEPS Action 2 Final Report, supra n. 1, refers to the ‘same control group’ instead of ‘associated enterprises’. See margin nr. 16.

174 See margin nrs. 18 ff.

175 A ‘financial trader’ is a person or entity engaged in the business of regularly buying and selling financial instruments on its own account for the purposes of making a profit. (Art. 2, §9, al. 3, k) ATAD).

176 An ‘on-market hybrid transfer’ means any hybrid transfer i.e. entered into by a financial trader in the ordinary course of business and not as part of a structured arrangement. (Art. 2, §9, al. 3, m) ATAD).

177 Art. 2, §9, al. 2, a) ATAD.

178 Art. 2, §9, al. 2, a) ATAD refers to Art. 2, §9, al. 1 a) ATAD.
return on the transaction. However, unlike the ATAD, the payment (representing the underlying return) made by the financial trader might still be treated as falling within the scope of the hybrid financial instrument rule to the extent that it produces a D/NI outcome. 180

4.3.2 Material Scope: Payments Under Financial Instruments and Hybrid Transfers

74. The ATAD formulates two categories of arrangements dealing with financial instruments. 181 The first category results from conflicts with payments made under a financial instrument that produces a financing or equity return. The hybrid mismatch will arise when a deductible payment under a financial instrument is not included in the taxpayer’s taxable income.

The second category focuses on hybrid transfers that generate a difference in tax treatment if, as a result of an arrangement to transfer a financial instrument, the underlying return on that instrument is treated as being received by more than one of the parties to the arrangement.

4.3.2.1 First Category: Payments Made Under a Financial Instrument

75. Similar to the OECD recommendations, the first category intends to tackle mismatches caused by ‘payments made under a financial instrument’. As such, it is necessary to consider a financial instrument, a payment, and the association between the payment and the financial instrument. 182

76. The EU encourages Member States to treat ‘any arrangement that produces a financing or equity return as a financial instrument’. However, it is ultimately again left to the discretion of each Member State to determine whether an arrangement is actually considered as one, hence, each Member State might have its own interpretation as to whether an arrangement is a financial instrument.

77. As mentioned, two separated flows can be detected under the arrangement: value is transferred to the payee for which a financing or equity return is paid under the arrangement. What is at stake is the tax treatment of the financing or equity return under the rules for taxing debt, equity, or derivatives under the domestic law. 185

78. The definition of the term ‘financial instrument’ states that the return of the arrangement must be taxed under the domestic rules for taxing debt, equity, or derivatives under the laws of either the payee or payer jurisdictions. 181 Hence, a hybrid mismatch could arise because only one party considers an arrangement as a financial instrument. Whereas the OECD BEPS Action 2 Report refers to the tax treatment under the laws of both the payee and payer jurisdiction, it also further states that a mismatch can also arise when only one party treats an arrangement as a financial instrument. Therefore, finally, both regimes accept a single State qualification as a financial instrument to be sufficient to the extent that the payment constitutes a financing or equity return. 185

79. The ATAD addresses mismatches arising from differences in the characterization of the payments made under a financial instrument. 186 As hybrid

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179 See T. Balco, Eurotaxus Union ATAD 2: Anti-Tax Avoidance Directive, 57(4) Eur. Tax., nr. 4, 156 (2017), referring to OECD BEPS Action 2 Final Report, supra n. 1, nr. 52, at 33: ‘Taxpayers that buy and sell securities in the ordinary course of a business of dealing or trading in securities (such as securities dealers, banks and brokers) will treat the net profit or loss on each trade as included in taxable income, or deductible for tax purposes, as the case may be, regardless of the exact way in which the transaction is accounted for or the manner in which the transaction is analysed for tax purposes.’

180 See OECD BEPS Action 2 Final Report, supra n. 1, Example 1.28, at 249. It remains unclear whether, according to the OECD, this can still cause the secondary (defensive) rule to apply for the counterparty. In any case, inspiration can be found at the end of recommendation 1 which states that, in the case that the payment by an investment vehicle is excluded, ‘the defensive rule ... will continue to apply to any payment made by such an investment vehicle’. See OECD BEPS Action 2 Final Report, supra n. 1, at 24.

181 Although the aim of the ATAD was to provide a framework i.e. consistent with and no less effective than the OECD BEPS Action 2 Report, it does not seem to address arrangements involving the transfer of financial instruments when a payment is made in substitution for the financing or equity return on the transferred asset and differences between the tax treatment of that payment and the underlying return on the instrument have the net-effect of undermining the integrity of the hybrid financial instrument rule (substitute payments).

182 See margin nos. 25 ff.

183 See margin no. 27.

184 Art. 2, §9, al. 3, i ATAD.

185 See margin no. 27.

186 Preamble nr. 16 ATAD II.
mismatches are the result of payments made under a financial instrument.\textsuperscript{187} It is acceptable to assume that a unilateral tax deduction that is not linked to any payment obligation of the issuer (e.g. notional deduction measures) will not be in scope of the hybrid mismatch rule.\textsuperscript{188}

4.3.2.2 Hybrid Transfers

80. To align the EU rule with the OECD recommendations, the ATAD also covers hybrid transfers. They generate a difference in tax treatment if, as a result of an arrangement to transfer a financial instrument, the laws of two jurisdictions differ on whether the transferor or the transferee has the ownership of the payments on the underlying asset or when the underlying return on that instrument is treated as (simultaneously) being received by more than one of the parties to the arrangement.\textsuperscript{189} As said, although such transfers are not financial instruments, as such, but rather arrangements involving a financial instrument, the OECD report nonetheless included them in the definition of a financial instrument as is followed in the ATAD.

81. Hybrid transfers target sale, repurchase (repo), and securities lending transactions.\textsuperscript{190} These structures are not impeded as such. The ATAD only addresses the tax consequences when these structures are aimed at benefitting from a mismatch situation.\textsuperscript{191} As illustrated, this could be the case if only one resident State of a party to an arrangement recognizes a transfer of assets as such.

The different tax treatment results in a mismatch outcome if one jurisdiction treats a payment connected with the income related to and derived from the transferred instrument as a deductible expense while the other jurisdiction regards the same amount as a (tax-exempt) return on the underlying asset itself. The hybrid transfer could also generate a surplus tax credit for the tax withheld at the source on the underlying instrument.

4.3.2.3 Mismatch Attributable to the Terms of the Instruments

82. Unlike the OECD BEPS Action 2 Report,\textsuperscript{192} the ATAD does not specifically mention that a payment under one of both categories (only) results in a hybrid mismatch when the mismatch can be 'attributed to the terms of the financial instrument'. However, according to the ATAD, a payment under a financial instrument (only) creates a hybrid mismatch if the mismatch outcome is 'attributable to differences in the characterization of the instrument or the payment made under it'.\textsuperscript{193} These terms raise some questions. The precise meaning of 'characterization' is ambiguous. It would have been clearer if the terms 'tax classification' or 'tax treatment' were used. In addition, the ATAD addresses mismatches that are the result of differences in the characterization of the payments under a (financial) instrument or the instrument itself. Does it mean that, unlike the OECD BEPS Action 2 Report,\textsuperscript{194} the differences in the characterization of the payment do not have to be attributable to the terms of the instrument?\textsuperscript{195} Although not integrated in the Directive, the preamble of the ATAD II specifically stipulates that tax outcomes that are 'solely' attributable to differences in the value ascribed to a payment

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\textsuperscript{187} The definition of 'deduction without inclusion' also refers to a 'deduction of a deemed payment'. However, this is only relevant for deemed payments between the head office and a permanent establishment or between two or more permanent establishments whereas the payment is disregarded under the laws of the payee jurisdiction.

\textsuperscript{188} Similar to the OECD BEPS Action 2 Final Report, supra n. 1, see margin nr. 31.

\textsuperscript{189} Art. 2, §9, al. 3, l) ATAD.

\textsuperscript{190} See supra margin nr. 35.


\textsuperscript{192} See margin nr. 82 ff.

\textsuperscript{193} As explained in the first part, the hybrid financial instrument rule under the OECD BEPS Action 2 Report only looks at the expected tax treatment of the arrangement based on the terms of the instrument and the character of the payments made under it to determine whether the payment gives rise to a mismatch.

\textsuperscript{194} According to the preamble nr. 13 of ATAD I, hybrid mismatches were the consequence of differences in the 'legal characterization of payments' (of financial instruments).

\textsuperscript{195} The recital of the preamble was not translated in the rules. Art. 2, §9 ATAD I only addressed mismatches resulting from conflicts in the 'legal characterizations of financial instruments' (to the extent that such rules do not affect the general features of the tax system of a Member State). Thus, the ATAD I did not address mismatches that are the result of differences in the tax treatment of the payments under a financial instrument. Also the term 'legal' characterization incited discussions as it is the difference in the tax treatment (or tax classification) that leads to a mismatch in the (tax) outcome.
including through the application of transfer pricing should not fall within the scope of a hybrid mismatch.\textsuperscript{196} Furthermore, a payment under a financial instrument will not generate a hybrid mismatch if the tax relief that is granted in the payee jurisdiction is ‘solely’ due to the tax status of the payee or because the instrument is held under the terms of a special regime.\textsuperscript{197}

83. This means that – in accordance with the OECD BEPS Action 2 Report – differences that are ‘solely’ attributable to the status of the taxpayer or the circumstances in which the instrument is held will not result in a hybrid mismatch. For example, gains and losses from foreign currency fluctuations on a loan can generate mismatches in tax outcomes, however, these mismatches are solely attributable to differences in the measurement of the value of payment (rather than its character).

Additionally, a mismatch in tax treatment that arises in respect of a cross-border payment made to a taxpayer in a ‘special regime’ will not be corrected. This measure is probably meant to mirror the OECD statement that the hybrid financial instrument rule does not apply to mismatches that are solely attributable to the context under which an instrument is held (e.g. payments to a taxpayer in a pure territorial regime).\textsuperscript{198}

4.3.2.4 Regulatory Capital Instruments

84. The OECD could not reach consensus with regard to mismatches under intra-group hybrid regulatory capital. Although clarifying that regulatory capital instruments were not intended to be captured by the hybrid financial instruments rule, the final determination was left to the discretion of each individual State. Interactions between the hybrid mismatch rule and the regulatory capital instruments, therefore, could result in unintended outcomes and potentially discourage financial institutions creating AT1 and AT2 capital, although they are required to issue additional capital instruments in order to replenish their regulatory capital.\textsuperscript{199} A solution for these conflicting international tax and regulatory concerns was certainly necessary.

85. Different Member States were nonetheless initially reluctant to provide a specific carve-out for regulatory capital instruments as this could create loopholes and lead to abuses from the financial industry.\textsuperscript{200} Nevertheless, to reconcile these concerns, the ATAD provides – without prejudice to the State aid rules\textsuperscript{201} – the possibility to exclude from its scope (and, as such, allow double non-taxation) a payment of interest under a financial instrument to an associated enterprise. The payment is excluded if the instrument has been issued with the sole purpose of meeting the issuer’s loss-absorbing capacity requirements and not for the purposes of avoiding tax.\textsuperscript{202} As such, Member States have the option of excluding an intra-group financial instrument with conversion, bail-in, or write down features from the scope of the hybrid financial instrument rule. This is allowed only if that instrument has been issued with the sole purpose of satisfying regulatory capital requirements and not to obtain a tax advantage. In addition, the mismatch in tax outcomes may only be expected to result in a single deduction under the structure. This means that the overall net deduction for the consolidated group under the arrangement does not exceed the deductible amount it would have had if the taxpayer had issued such a financial instrument directly to the market.\textsuperscript{203}

This involves contingent capital securities issued by financial institutions intended to provide leverage in good economic times and provide a buffer (i.e. loss absorption) under stress scenarios when it would be

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\textsuperscript{196} Preamble nr. 22 ATAD II.

\textsuperscript{197} Preamble, nr. 16 ATAD II.

\textsuperscript{198} See margin nr. 59.

\textsuperscript{199} See margin nn. 41 ff.

\textsuperscript{200} See also Balen, supra n. 180, at 128.

\textsuperscript{201} This option to deduct and not include the same payment might under specific circumstances lead to the infringement of State aid rules. For example, the Dutch Government announced ending the favourable tax treatment of CoCo securities. As from 1 Jan. 2019, the tax deductibility of the coupon paid on Additional Tier 1 cap


\textsuperscript{203} Art. 9, § 4, b) ATAD.
difficult for them to raise capital. The rule targets the banking sector\textsuperscript{204} in connection with consolidated groups issuing such financial instruments for the purposes of meeting loss-absorbing capacity requirements. 86. The carve-out rule is optional. Each Member State decides whether or not the exclusion for intra-group regulatory capital will be applicable. Member States may continue to protect their tax base through the use of the hybrid mismatch rules. As this creates potential differences between Member States, the uncertainty already criticized under the OECD report is finally maintained.

87. Given the controversy with regard to the implementation, the exclusion may temporarily be applied by Member States until 31 December 2022 and shall be evaluated by the European Commission by 1 January 2022.

### 4.4 Mismatch in Tax Outcome: D/NI Mismatch

88. The ATAD definitions of mismatches are in accordance with BEPS Action 2. Hybrid mismatches under the ATAD will arise when a (part of a) payment is made under a financial instrument to the extent that the payment is deductible under the laws of the jurisdiction in which that payment is treated as being made (the payer jurisdiction) without a corresponding inclusion\textsuperscript{207} for tax purposes in the jurisdiction where that payment is received or is treated as being received under the laws of any other jurisdiction (payee jurisdiction).\textsuperscript{208} This will result in a D/NI outcome.

89. The directive acknowledges that jurisdictions can employ different tax accounting periods and have different rules for recognizing the moment when items of income (particularly dividend or interest) or expenditure have been received or incurred. These timing differences are not treated as giving rise to mismatches in tax outcomes. Although the ATAD II preamble allows States to require that a payment be included within a fixed period of time,\textsuperscript{209} Article 2, §9, al. 2 ATAD not only states that a payment should be ‘treated as included in income within a reasonable period of time where the payment is 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’. It further continues that this will also be the case if ‘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 are those that would be expected to be agreed between independent enterprises’. 90. As the ‘payment’ must be recognized ‘within a reasonable period of time’, it seems logical to assume this ‘reasonable period of time’ for income inclusion only begins after the payment of the remuneration under the hybrid financial instrument.\textsuperscript{210} However,

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**Notes**

204 At first, reference was made to the banking and other regulated entities (e.g. insurance companies). See EU Council, Proposal for a Council Directive Amending Directive (EU) 2015/1164 as Regards Hybrid Mismatches with Third Countries – General Approach supra n. 205; EU Council, Proposal for a Council Directive Amending Directive (EU) 2016/1164 as Regards Hybrid Mismatches with Third Countries (ATAD 2) – Explanation of Change in Art. 9(4)(b) and (c), supra n. 206. This was a compromise in order to find the right balance between the need to cater for an exemption and the need to control its strict application.

205 According to Art. 2, §9, al. 3, d) ATAD the term ‘deduction’ means the amount i.e. treated as being deductible from the taxable income under the laws of the payer or investor jurisdiction. The definition continues that the term ‘deductible’ shall be construed accordingly. However, it can be noticed that ‘deduction’ and ‘deductible’, in general, are not amounts but properties of a particular cost.

206 See Art. 2, §9 ATAD I initially only exploited differences in the tax treatment (of an instrument) under the laws of two or more Member States that resulted in a deduction of the income in one Member State where the payment had its source without inclusion in the tax base of the other Member State. Based upon domestic law, multiple Member States were considered as the ‘source State’. As the ATAD I did not explain how this requirement should be interpreted, it was difficult to establish in which country the payment had its source. See Balco, supra n. 180, at 128. Under ATAD II, the ‘source of the payment’ is no longer used. Art. 2, §9 ATAD refers to ‘any jurisdiction in which that payment is treated as made (payer jurisdiction)’. Unfortunately, this terminology might still lead to different interpretations.

207 According to Art. 2, §9, al. 3, c) ATAD, non-inclusion also encompasses the situation in which the payment qualifies for double tax relief if the character of the payment qualifies for double tax relief under the laws of the payer jurisdiction, such as an exception from tax, a reduction in the rate of tax or any credit or refund of tax (other than a credit for taxes withheld at source), the payment should be treated as generating a hybrid mismatch to the extent of the resulting undertaxed amount Art. 2, §9, al. 3, c) ATAD. The term ‘inclusion’ means the amount i.e. taken into account in the ‘taxable income’ under the laws of the payee jurisdiction. A payment under a financial instrument shall not be treated as being included to the extent that the payment qualifies for any tax relief solely due to the fact that payment is characterized under the laws of the payee jurisdiction.

208 See Art. 2, §9, al. 3, c) ATAD. The hybrid mismatch instrument rule in the ATAD I initially only exploited differences in the tax treatment (of an instrument) under the laws of two or more Member States which resulted in a deduction of the income in one Member State (where the payment has its source) without inclusion in the tax base of the other Member State. Based upon the domestic law, multiple Member States could be considered as the ‘source State’. As the ATAD I did not explain how this requirement was interpreted, it was difficult to establish in which country the payment had its source. See also Balco, supra n. 180, at 128. Balco mentions that ‘Member States could also take a restrictive approach to the question of whether a payment has its source in a Member State and taxpayers could circumvent the effect of the rules in the Directive simply by making the payment through a taxable branch located in a third country.’

209 Preamble nr. 22 ATAD II.

210 See also Santos, supra n. 41, at 510–511. This understanding derives from the fact that interest expenses are usually deductible under a pro-rata method, i.e. pro rata tempore, while dividends are only computed in the taxable income of the beneficiary on the approval of the dividend distribution by the general shareholder meeting.
whereas the OECD report was criticized for its ambiguity, this vagueness has also been implemented in the directive. Although the BEPS Action 2 Report provides some additional information, this rule could still lead to different interpretations between Member States. Ensuring a situation in which market participants have a fair and equal chance of succeeding and a common standard for countering tax arbitrage with third countries, however, requires this rule to be applied as uniformly as possible. The remaining vagueness, therefore, must be deplored.

4.5 Neutralizing the Hybrid Financial Mismatch

4.5.1 Particular Measures for the Tax Treatment of Financial Instruments

91. The ATAD does not explicitly refer to Recommendation 2.1. of the OECD BEPS Action 2 Report that limits the availability of a dividend exemption or equivalent tax relief for payments treated as being deductible by the payer. Only when the P/S-directive is applicable does Article 4, 1a obligate refusing an exemption and taxing the distributed income. As already illustrated in margin nr. 49, this recommendation only seems to be effective in a rather bilateral context and will probably not resolve a mismatch when additional States are involved.

92. Although the OECD BEPS Action 2 Report provides specific recommendations against the duplication of tax credits under a hybrid transfer, the ATAD only refers to the application of a general anti-abuse rule consistent with Article 6 ATAD to prevent taxpayers from exploiting the surplus credit to obtain a tax advantage.

4.5.2 Two-tiered Approach: Restricting the Deduction of a Payment or Taxing the Income

93. Article 9, §2 ATAD I initially stated that ‘to the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment’. As its initial scope was limited to hybrid mismatches that arose (wholly) within the European Union, there seemed to be no need to adopt the defensive rule in the ATAD I. 94. With the extension of its scope to third-country situations, the defensive rule also had to be implemented to ensure the effectiveness of the hybrid financial instruments mismatch rule. Therefore, at present, Article 9, §2, b) ATAD provides that ‘where the deduction is not denied in the payer jurisdiction’, the Member State being the payee jurisdiction must apply the defensive rule and include the amount of the payment in the taxable income of the beneficiary.

95. In addition, as previously mentioned, the hybrid mismatch rules can be easily circumvented by importing a mismatch outcome between two (foreign) States into a third State (e.g. by financing the creation of this mismatch conflict). Therefore, according to Article 9, § 3 ATAD, ‘a Member State shall deny a deduction for any payment by a taxpayer to the extent that such payment directly or indirectly funds deductible expenditure giving rise to a hybrid mismatch [ … ] except to the extent that one of the jurisdictions involved in the transaction or series of transactions has made an equivalent adjustment in respect of such hybrid mismatch’. This adds the imported mismatch rule as a third possible reaction.

96. In accordance with the OECD BEPS Action 2 Report, the linking rules only apply to payments under the financial instrument and should not affect the general features of a tax system no matter if it is a classical or an imputation system. Furthermore, as the two-tiered approach is based on the linking rules of the OECD BEPS Action 2 Report, in general, the same remarks made in the analyses of the OECD hybrid financial instrument rule are, as such, relevant. However, the binding effect of the directive adds further complications.

97. The defensive rule provides an effective solution for a qualification conflict with a third State not (or more restrictively) implementing the

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211 Preamble nr. 23 ATAD II. It is remarkable to notice that also the first part of recommendation 2 (no longer providing for an exemption) has not been integrated into the ATAD but is only partly reflected in Art. 4 PS Directive.

212 See margin nr. 50.

213 Preamble nr. 25 ATAD II.

214 Although Art. 9, § 2 ATAD only refers to ‘inclusion in income’, it is noteworthy that, according to Art. 2, §9, al. 3, e) ATAD, ‘inclusion’ means the amount i.e. taken into account in ‘the taxable income’ under the laws of the payer jurisdiction.

215 The equivalent adjustment that will be taken into account for the twelve months safe harbour period for considering tax period differences is uncertain.

216 Preamble nr. 9, ATAD II.
primary rule.\footnote{In this context, however, Fibbe and Stevens mention that ‘implementing the defensive rule to all possible situations of non-appliance with the primarily rule seems almost an impossible mission for the national legislators.’ See Fibbe & Stevens, supra n. 162, at 162.} In addition, Article 9, §3 ATAD provides a solution for an imported mismatch from two other States that did not implement equivalent adjustments. However, the secondary and third solution apply in general terms ‘when the other States have no equivalent adjustments’. This raises the question of what happens if an EU Member State does not fulfil its obligations to fully implement the ATAD or if a (complying) Member State provides solutions already before the final deadline of 1 January 2020, the moment from which all Member States should comply with the directive. Is the defensive rule applicable when another EU Member State does not apply the primary rule? Can the imported mismatch rule apply to financed mismatches between other (non-complying) EU-Member States?\footnote{However, Fibbe and Stevens are of the opinion that a Member State (payee jurisdiction) should apply the defensive rule if another Member State acts in time, the European Commission has the authority to initiate an infringement procedure against this Member State. However, the infringement procedure could take several years and incite uncertainty for all concerned jurisdictions. Additionally, infringement proceedings will not resolve existing hybrid mismatches that arise between Member States.\footnote{For more details regarding this topic, cf. P. B. Regil, BEPS Action 2, 1 and 4 and the Fundamental Freedoms: Is There a Way Out?, 5606 Eur. Tax’n 230–245 (2016); J. Bundgaard, Hybrid Financial Instruments and Primary EU Law – Part 1, 53(11) Eur. Tax’n 442–456 (2013); J. Bundgaard, Hybrid Financial Instruments and Primary EU Law – Part 2, 53(11) Eur. Tax’n 587–594 (2013).}}

If a Member State acting as a payer or payee jurisdiction fails to implement the linking rules in time, the European Commission has the authority to initiate an infringement procedure against this Member State. However, the infringement procedure could take several years and incite uncertainty for all concerned jurisdictions. Additionally, infringement proceedings will not resolve existing hybrid mismatches that arise between Member States.\footnote{See aida Balos, supra n. 180, at 128. According to Balos, the question for the application of the defensive (or third) solution can be raised if Member States take a restrictive approach to the interpretation and implementation of the directive (particularly regarding identifying whether or not a particular mismatch is ‘attributable to differences in the legal characterization of a financial instrument or entity’).}

Based on the general terminology of Article 9, §2, b) ATAD (‘where the deduction is not denied in the payer jurisdiction’) and Article 9, §3 ATAD (‘except to the extent that one of the jurisdictions involved … has made an equivalent adjustment’), one might be inclined to conclude that the secondary/third solution becomes applicable. However, according to preambles nr. 24 ATAD II, the defensive rule was meant to ‘provide for a rule that allows Member States to tackle discrepancies in the transposition and implementation of this Directive resulting in a hybrid mismatch despite the fact that Member States act in compliance with this Directive. Where such a situation arises and the primary rule provided for in this Directive does not apply, a secondary rule should apply’. For all other cases (when the payer jurisdiction is a Member State), therefore, it can be considered reasonable to conclude that Member States are not obligated to implement the defensive rule in their domestic legislation.\footnote{Cf. Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, B. Fibbe & Stevens, Part 1 n. 162, at 162.}

If, however, domestic rules apply in accordance with the OECD standards, this would still lead towards the application of a defensive (or third) solution when a State is confronted with other non-complying States regardless of their status as an EU-Member State or a third State. In itself, this cannot be considered as violating the ATAD outcome.

### 4.6 Hybrid Financial Instrument Rule and Primary EU Law

98. According to its explanatory memorandum, the ATAD establishes legally binding rules to tackle corporate tax avoidance in a way that preserves EU Member States’ collective competitiveness and respects the Single Market, Treaty Freedoms, the EU Charter of Fundamental Rights, and EU law in general.\footnote{See also this Directive. Where such a situation arises and the primary rule provided for in this Directive does not apply, a secondary rule should apply.} Being part of secondary EU Law, the hybrid mismatch rules of Article 9 ATAD have to respect the limitations imposed by EU primary law. Therefore, it is relevant to consider the interaction between the ATAD and the EU fundamental freedoms. This article, however, is not meant to provide an extensive analysis but only indicates the most important remarks that can be made with regard to this question.\footnote{See supra n. 180, at 128. According to Balos, the question for the application of the defensive rule to all possible situations of non-appliance with the primarily rule seems almost an impossible mission for the national legislators’. See Fibbe & Stevens, supra n. 162, at 162. Even though the secondary and third solutions already before the final deadline of 1 January 2020, the moment from which all Member States should comply with the directive. Is the defensive rule applicable when another EU Member State does not apply the primary rule? Can the imported mismatch rule apply to financed mismatches between other (non-complying) EU-Member States?}
99. In particular, Article 49 Treaty on the functioning of the European Union (TFEU) (freedom of establishment) and 63 TFEU (free movement of capital) appear to be at stake. However, as only the free movement of capital also applies with regard to third States, the distinction between both freedoms should be carefully considered. This depends on whether the rule applies with regard to shareholdings that are only maintained as a financial investment without possibilities to influence the management and/or control of a company or only affects controlling participations.\textsuperscript{222}

100. It is nonetheless possible that both fundamental freedoms overlap with each other.\textsuperscript{223} The purpose of the legislation that is concerned must then be taken into consideration (as well as whether, in the circumstances of the primary proceedings,\textsuperscript{224} one of those prevails over the other).\textsuperscript{225} The European Court of Justice (ECJ) will challenge the measure in dispute against only one of those two freedoms if it appears from the circumstances of the case that one freedom is entirely secondary in relationship to the other and may be considered together with it.\textsuperscript{226} Nonetheless, in most cases involving direct taxation, the ECJ seems to give precedence to other freedoms over the free movement of capital.\textsuperscript{227}

101. Once the applicable freedom is determined, the question arises as to whether the two tiered approach is discriminatory or restricts free movement. Considering the prerequisite of a mismatch, these rules only apply between two different legal systems and, therefore, require a cross border context. Whereas the primary rule (rejecting a generally accepted deduction) clearly restricts free movement, the question was raised as to whether the defensive rule could also be seen to have this detrimental effect. According to Regil, it follows that even though the defensive rule is liable to have a detrimental effect in the majority of the situations in which taxpayers enter into financial instruments with non-residents, the fact that the defensive rule applies precisely because there is no economic double taxation when the profits were deductible at the level of the payor makes the rule non-discriminatory.\textsuperscript{228} It is possible, however, that the ECJ will examine the defensive rule under a restriction approach. As the defensive rule will only lead to the inclusion of the amount of the payment in the income in a Member State due to the fact that it is deductible in another jurisdiction, it would be fairly clear to conclude that the measure has a restrictive effect.

102. If one (or both) of the linking rules are considered to be restrictive (whether or not discriminatory), possible justifications for this restriction might be sought. An examination of the objectives of the ATAD could particularly reveal the coherence of the tax system, the balanced allocation of taxing rights, and preventing tax avoidance.\textsuperscript{229}

Considerations relating to the coherence of the tax system may only be relied upon when the taxpayer is one and the same person, and there is a direct association between the fiscal advantage granted to a taxpayer and taxes due.\textsuperscript{230} As the hybrid financial instrument rule does not relate to the taxation of one single taxpayer, it seems unlikely that the linking rules will be justified based on the ‘coherence of the tax system’. Additionally, a justification based on the need to ‘preserve a balanced allocation of taxing rights’ seems to be difficult to apply. The ECJ stated, regarding the balanced allocation between Member States of the power to tax, that a justification is acceptable when a system is designed to prevent conduct that is capable of undermining the

\textbf{Notes}

\begin{itemize}
  \item [\textsuperscript{223}] See R. Barrenes & L. J. Brinkhorst, \textit{Groothoek van Europese recht}, 664 (Kluwer, 2006).
  \item [\textsuperscript{224}] However, in some cases, the ECJ has also moved away from the factual situation test and has combined the purpose of the law with the access to the market criterion. See A. P. Dourado, \textit{The EU Free Movement of Capital and Third Countries: Recent Developments}, supra n. 222, at 199.
  \item [\textsuperscript{225}] PL: ECJ, 10 Apr. 2014, Case C-190/12, Emerging Markets Series of DFA Investment Trust Company v. Dyrekrona Szarlowny i Brygierzy, ECLI:EU:C:2014:249, para. 25; Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue, Commissioners for Her Majesty’s Revenue & Customs, (Case C-35/11) supra n. 222, para. 96; AT: ECJ, 24 May 2007, Case C-157/05, Holmbv v. Finanzamt Salzburg Land ECLI:EU:C:2007:297, para. 22; Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue, (C-196/04), supra n. 223, para. 31–35.
  \item [\textsuperscript{227}] See Santos, supra n. 41, at 308; A. P. Dourado, \textit{Free Movement of Capital: The European Union Anti-Tax Avoidance Package and Brexit}, supra n. 222, at 872.
  \item [\textsuperscript{228}] See Regil, supra n. 222, at 235.
  \item [\textsuperscript{229}] For more details regarding this topic, see Bundgaard, \textit{Hybrid Financial Instruments and Primary EU Law – Part 2}, supra n. 222, at 587–594.
\end{itemize}
right of Member States to exercise their tax jurisdiction in relationship to the activities conducted in their territory and thus jeopardizing a balanced allocation between Member States of the power to impose taxes.\(^{231}\)

However, as mentioned in margin nr. 2, the purpose of linking rules is not to protect the tax base of a certain Member State but to tackle the general outcome of double non-taxation caused by hybrid mismatches.

Considering that the key objective of the ATAD is to improve the resilience of the internal market against tax avoidance risks arising from the manipulation of hybrid mismatches, the prevention of tax avoidance/tax abuse could be the most effective justification for restrictions on the fundamental freedoms. In several cases, however, the ECJ stated that rules aimed at preventing tax avoidance may (only) be justified when they specifically target ‘purely artificial arrangements with the objective of circumventing the relevant Member State’s legislation.’\(^{232}\)

Financial instruments are generally not artificial as transactions with hybrid financial instruments are not only carried out to obtain a tax advantage. The tax advantage is merely a consequence of a conflict in the characterization of the instrument (and hence the tax treatment of the payments made under it).\(^{233}\) Additionally, the mere fact that (corporate) taxpayers exploit an inconsistent treatment does not necessarily mean that there is avoidance behaviour.

Based on the above, it is acceptable to assume that the objectives invoked by the ATAD, as such, do not fully justify an impediment to the relevant TFEU provisions.

103. Moreover, even if general justifications were withheld, the proposed measures cannot go beyond what is necessary to achieve these objectives.

The automatic nature and the broad scope of application of the linking rules (‘any payment’ under a hybrid financial instrument that results in double non-taxation between related parties) can hardly be considered as strictly proportional. The hybrid mismatch rule does not provide the taxpayer with an opportunity to substantiate that the transactions are economically motivated or even purely for commercial reasons (with a specific exception for financial traders\(^{234}\)). As such, the rules do not seem to pass the proportionality-test.

104. In conclusion, the linking rules might be considered as violating the EU free movement of capital (and/or establishment). However, this short descriptive chapter only raises the question and some criticism without extensively concluding this complex question. The final word is left for the ECJ.

5 Conclusion

105. Over the last decade, several solutions have been proposed to deal with hybrid financial instruments. Unfortunately, both the OECD and the European Council missed the opportunity to address the cause of the hybrid mismatches. Apparently, it appears to be impossible to implement a uniform tax treatment of financial instruments while eliminating the possibility for mismatches among different countries.

As an alternative to neutralize the effects of hybrid financial instruments, countries will have to adopt a single set of integrated linking rules that provide for clear and transparent outcomes under the laws of all of the jurisdictions applying the same rules. Although not reaching harmonized treatment, the linking rules nonetheless make the tax treatment of a payment in one country dependent upon its treatment in the country of the counterparty. This linking hierarchy of solutions makes the application of the rules very complicated.

106. The solutions proposed by the OECD leave several ambiguities:

- Although meant to solve mismatches, the hybrid financial instrument rule only envisages tax reducing effects. A mismatch in tax outcomes leading towards extensive taxation due to characterization differences is disregarded.
- The mere outcome is considered to be abusive whereas obtaining a benefit does not necessarily reflect the intent of a concerned taxpayer to actively avoid taxes.

Notes

231 BE ECJ, 5 July 2012, Case C-318/10, Société d’investissement pour l’agriculture tropicale SA (SIAT) v. Belgian State, ECLI:EU:C:2012:415, para. 45; Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue, (C-196/04), supra n. 225, para. 56; UK: ECJ, 13 Dec. 2005, Case C-446/03, Marks & Spencer v. David Halsey (Her Majesty’s Inspector of Taxes), ECLI:EU:C:2005:763, para. 46.

232 Test Claimants in the Thin Cap Group Litigation, (C-324/00), supra n. 227, para. 57; Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue, (C-196/04), supra n. 225, para. 51; Marks & Spencer v. David Halsey (Her Majesty’s Inspector of Taxes), (C-446/03), supra n. 232, para. 57.; Lankhorst-Höhvel (C-324/00), supra n. 231, para. 37.

233 See margin nr. 6.

234 See margin nos. 72–73.
The linking rules reduce tax benefits but will not necessarily tax the income where the income is earned or the value is created. It ultimately does not matter where the income is taxed (i.e., whether the tax is collected under the primary or the defensive rule) as long as the income will be taxed at least once.

Finally, the interaction between domestic tax systems may still continue to generate tax loopholes. As such, e.g., the hybrid financial instrument rule is not applicable with respect to capital gains. Therefore, profits made on disposals of shares could be beyond its scope. Additionally, a payment to acquire a bond will not generate a mismatch in tax outcomes under the hybrid financial instrument rule (unless the contract to acquire the instrument is treated as a financial instrument or a hybrid transfer). Moreover, timing differences in characterization and the need for cash flow may possibly lead to tax arbitrage (or even tax avoidance). This could be the case when an instrument is first treated as equity but then is later reclassified retrospectively). The effectiveness of the so-called anti-avoidance measure could be limited and might subsequently mean that the problem of double non-taxation is still present in some cross-border cases.

107. With the publication of the ATAD II, the ATAD hybrid mismatch rules are brought into accordance with the OECD BEPS Action 2 recommendations. However, as clear indications are sometimes lacking, the preamble of the ATAD II simply referred to ‘the applicable explanations and examples in the OECD BEPS Action 2 report as a source of illustration or interpretation to the extent that they are consistent with the provisions of this Directive and with Union law’. However, as the general hybrid financial instruments mismatch rule might inherently violate EU law, it is not clear which parts of the report are consistent with EU law. In our opinion, the mere reproduction of linking rules proposed by the OECD BEPS Action 2 Report may restrict the free movement of capital and the freedom of establishment. It is unlikely that this restriction will fully pass the rule of reason as being applied by the ECJ.

108. This article aimed at comparing the EU implementation of the hybrid financial instrument mismatch rule with its OECD source. Whereas already minimal differences exist between the OECD proposal and the European Directive, larger differences will arise regarding the implementation of these rules in domestic tax law. Considering the high complexity, it remains rather doubtful whether all EU Member States will be able to correctly and consistently implement these rules in 2020.