

GHENT
UNIVERSITY

FACULTY OF LAW

INTERNATIONAL ASPECTS OF HYBRID MISMATCHES

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PRESENTATION

1. Introductive comments
2. 8 possible mismatches in entity qualifications
3. Importing mismatch from third countries
4. Conclusion

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FUNDAMENTALS OF HYBRID MISMATCHES

=> Conflict between different simultaneously applicable legislations

-domestic income tax legislation (common)

-tax treaties (less common => interpretation ?)

How to resolve conflict ?

-giving priority to one legislation over others => ‘priority approach’

-conceptually ‘neutralizing the mismatch effect’ => ‘conceptual approach’

(see also CFC, subject to tax-rules, …)

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FUNDAMENTALS OF HYBRID MISMATCHES

Focus in the partnership report (1999): unbalanced tax burden

=> *Conceptual approach*: residence state of the partner (R) avoids the mismatch

Reducing (excessive) double taxation / avoiding non-taxation

→ needs a particular interpretion of its relief obligation in the treaty in the residence state of the partner (R)

=> *Priority approach*: attribution of income (and treaty entitlement) is determined by the state of residence (P or R)

An implicit treaty principle binding the source state to the attribution rules of the residence state(s) to determine treaty applications

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FUNDAMENTALS OF HYBRID MISMATCHES

Focus in BEPS action 2: "*Neutralise the effect of a hybrid mismatch by ensuring that a payment is subject to tax at least once*"

=> (Limited) *priority approach*: attribution of income (and treaty entitlement) is determined by the state of residence (P or R)

as explicitly added in art. 1,2 OECD Model Convention

=> *Conceptual approach*: avoiding 'tax avoidance' by way of linking rules (D/NI, DD, NI/NI)

Mismatch is considered to be planned and should be avoided in domestic legislation being influenced by foreign legislation

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INITIATIVES IN ATAD 1 AND 2

=> Part attributed to domestic legislation

ATAD 2 ➔ "*it is clear that this cannot sufficiently be achieved by Member States acting individually, in a non-concerted mode*"

Subsidiarity ?

=> need for "*principle-based rules*" in a Directive

(Is the OECD wrong ? Is its guidance insufficient ?)

=> Proposal integrates possible (primary) results in third states

Proportionality ?

=> *the Directive does not prescribe full harmonisation, but only the protection which is required to safeguard Member States' corporate tax systems*"

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INITIATIVES IN ATAD 1 AND 2

- Reaction only in case of ‘associated enterprises’

  (but not completely clear who needs to be associated)

  => reactions against tax avoidance based on the use of hybrid mechanisms (entities or financial instruments)

  => Cf. definitions in art. 2, §4 and §9

➔ No concept of solving ‘mismatches’,

but **avoiding ‘abuse of mismatches’** to avoid taxation

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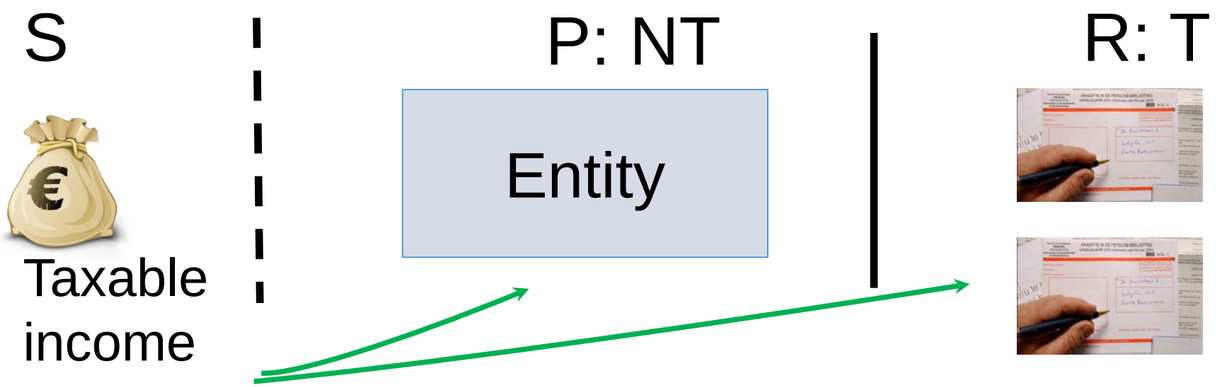
MISMATCH IN ENTITY QUALIFICATION

- Hybrid entity: receiving income
  paying expenses
  internal income flow to the entity
  internal income flow to the “shareholder”/partner/…

- Reverse hybrid entity:
  receiving income
  paying expenses
  internal income flow to the entity
  internal income flow to the “shareholder”/partner/…

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Hybrid entity: receiving income



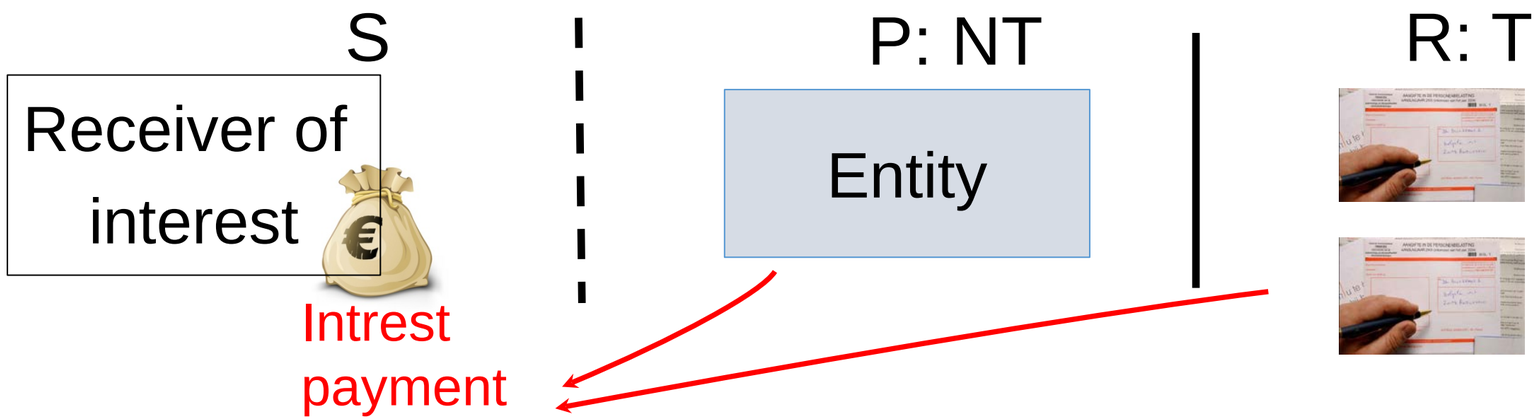
If state P: NT and state R: T ➔ Hybrid entity

=> state P taxes income at the level of the entity

=> state R has to avoid double taxation through the correct application of the treaty P-R, because state P taxes the income in accordance with the terms of the convention P-R (as interpreted by state P)

➔ NOW: ‘dual inclusion income’ ??? Case not dealt with

Hybrid entity: paying expenses



If state P: NT and state R: T ➔ Hybrid entity

=> states P and R deduct the interest payment from the taxable income

=> it is a DD in case the deduction is **not against dual inclusion income**

➔ <u>negative result</u> (primary attribution to di-income) from the payment,

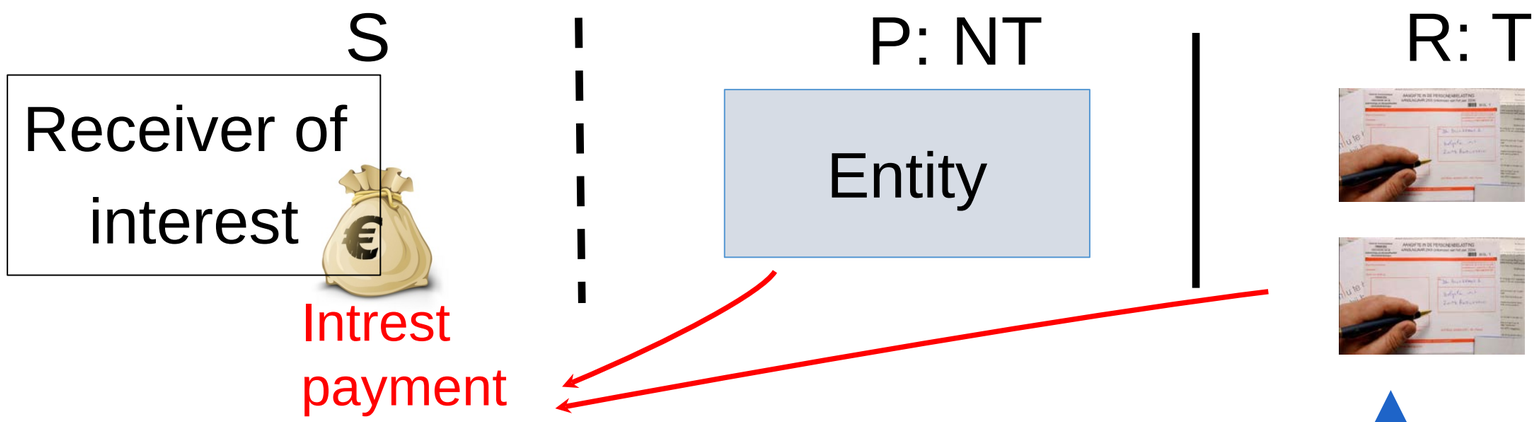
but some income is linked with entity in P, but not with partner in R

-receiver of interest is tax transparent according to P or

-receiver and entity in group tax regime according to P

- … other possibilities ? Other entities in P …

Hybrid entity: paying expenses

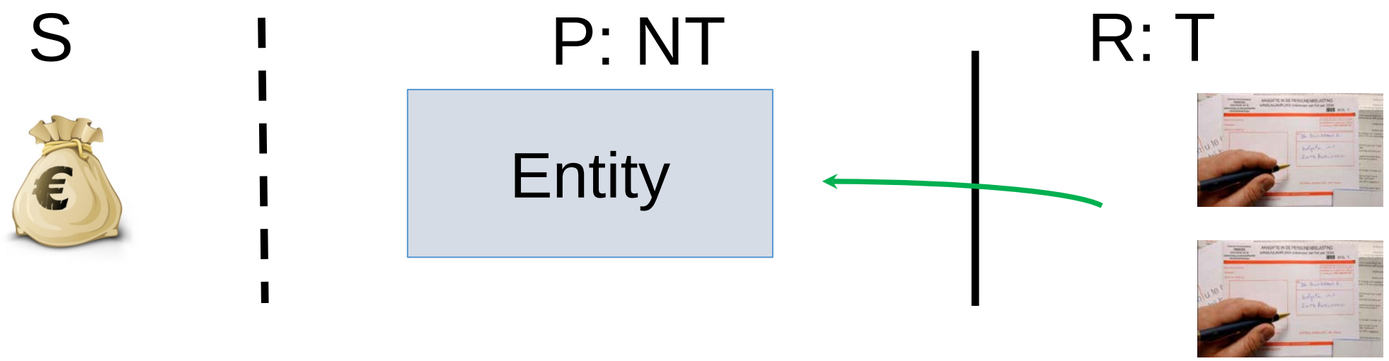


Art. 9, §1 Directive:

1. Refuse ‘excess’ deduction

2. Refuse ‘excess’ deduction in EU-Member State, unless already refused by third state

Hybrid entity: internal income flow to the entity



If state P: NT and state R: T ➔ Hybrid entity

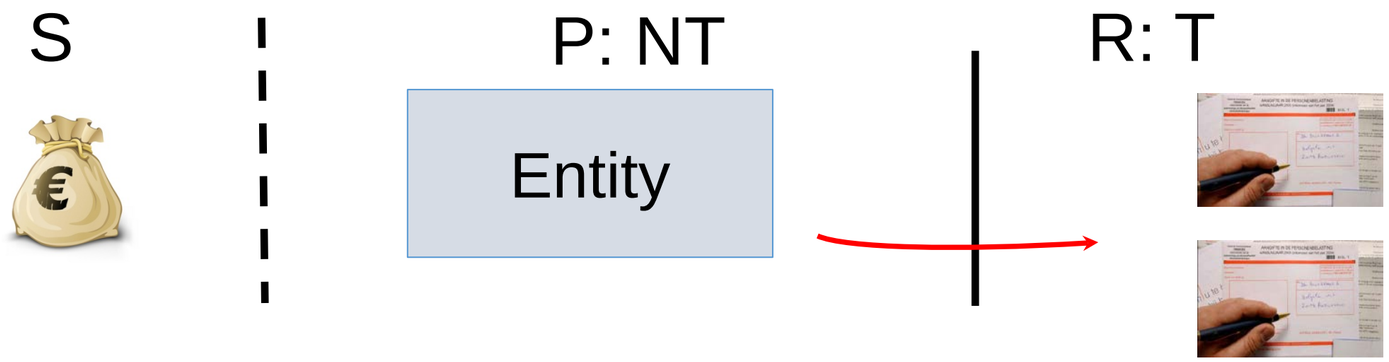
=> state P taxes income at the level of the entity

=> state R does not recognize the payment

➔ NOW: inclusion without deduction ??? Case not dealt with

➔ Supposing partners and entity are linked: situation can be avoided

Hybrid entity: internal income flow to the shareholder/partner



If state P: NT and state R: T ➔ Hybrid entity

=> state P deducts payment at the level of the entity

=> state R does not recognize the payment

➔ D/NI in case the deduction is **not against dual inclusion income**

income linked with entity in P, but not with partner in R

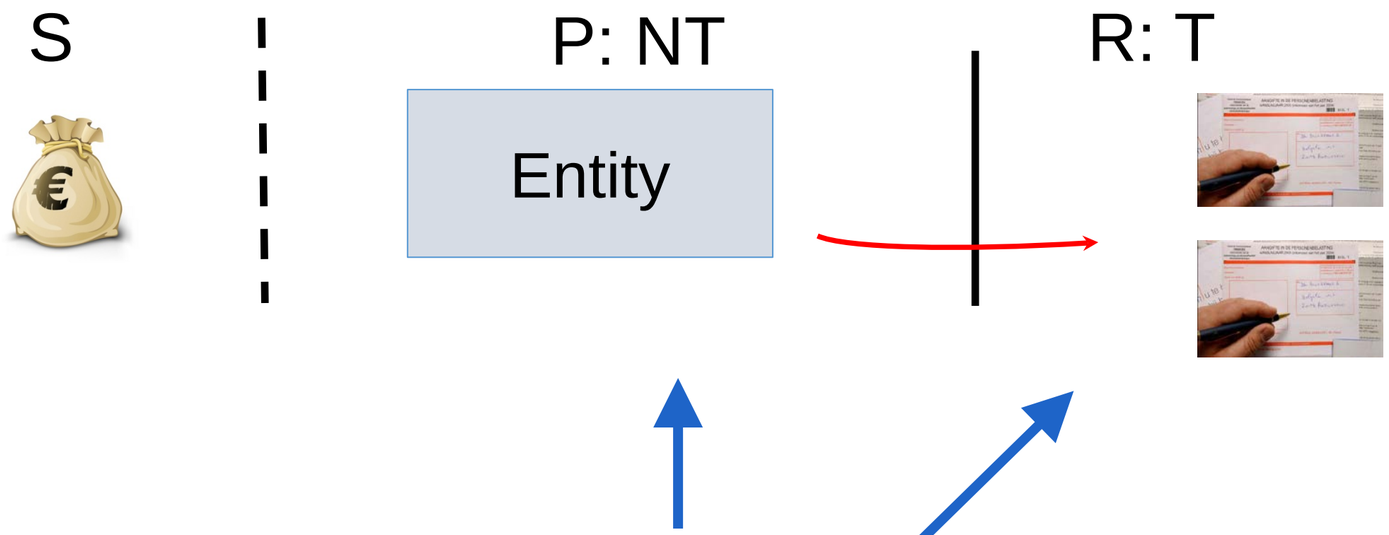
Directive: "*income from the same source*"

-entity in S is tax transparent according to P (and not according to R)

-group tax regime according to P

- … other possibilities ?

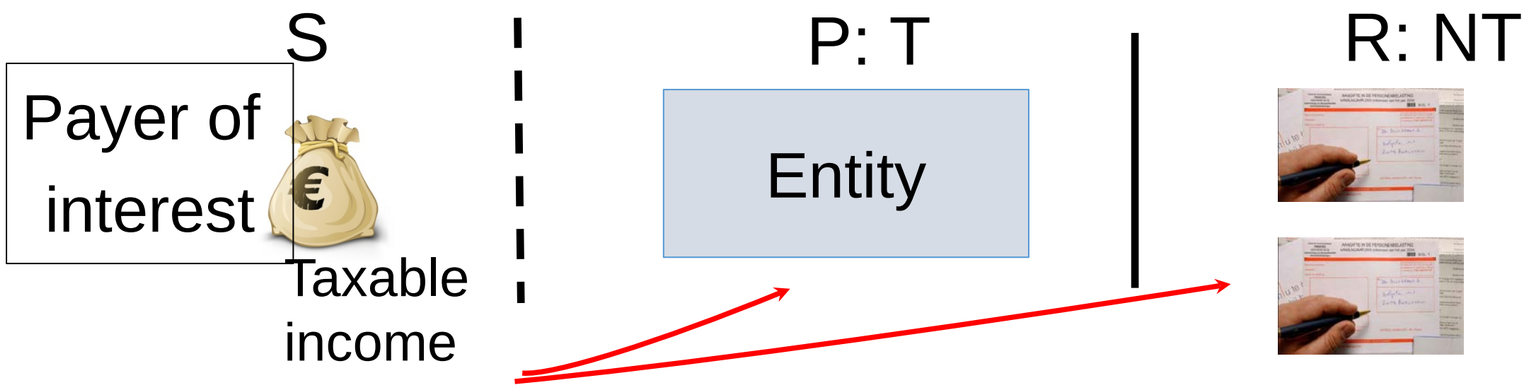
Hybrid entity: internal income flow to the shareholder/partner



Art. 9, §2 Directive: **1. Refuse 'excess' deduction**

2. Include in tax base of EU-Member State, unless deduction refused by third state

Reverse hybrid entity: receiving income



If state P: T and state R: NT ➔ Reverse Hybrid entity

=> state P taxes income at level of the partners (unless entity is PE in state P)

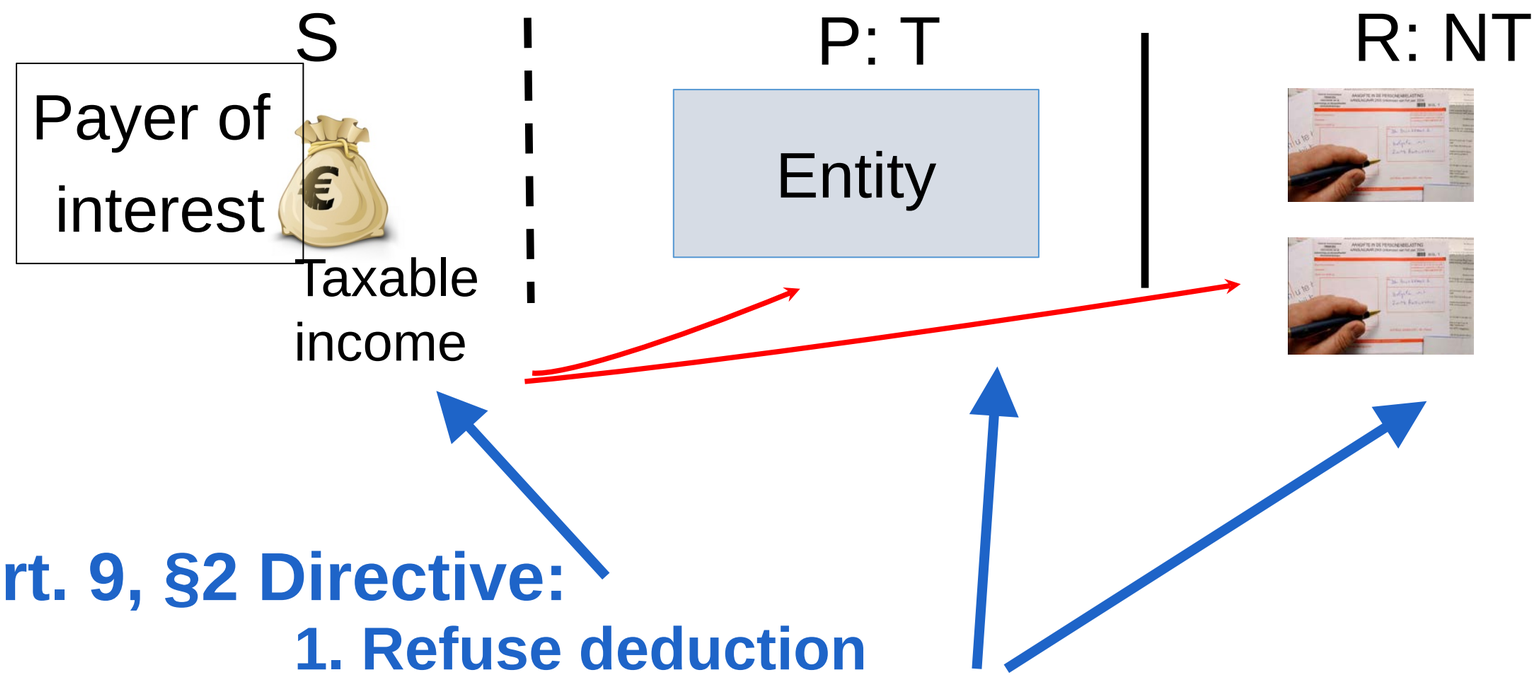
=> state R taxes income at level of entity

➔ no taxation: Deduction and no inclusion ?

Previously: R no longer has to exempt income, based on treaty ???

New solution: Art. 9, §2 Directive, depending on source of payment

Reverse hybrid entity: receiving income



Art. 9, §2 Directive:

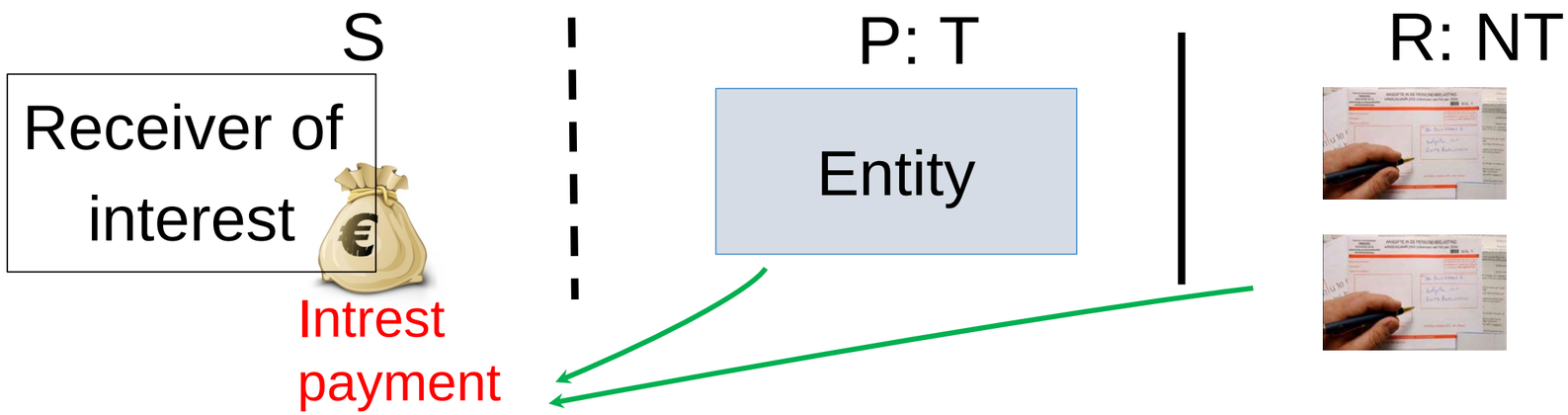
1. Refuse deduction

2. Include in tax base of EU-Member State,

unless deduction refused or income included by third state

(What is the “member state concerned” ???)

Reverse hybrid entity: paying expenses

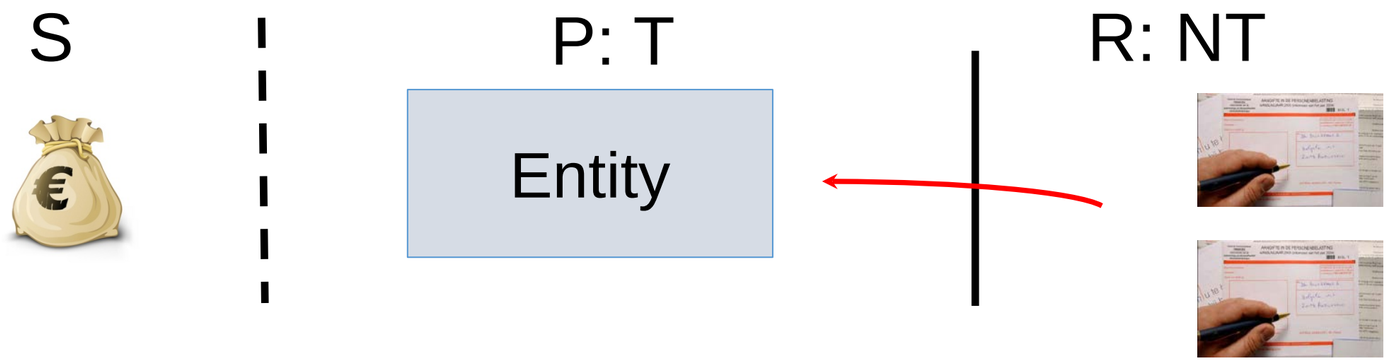


If state P: T and state R: NT ➔ Reverse hybrid entity

=> neither state P, neither R deduct the interest payment from the taxable income (unless entity is a PE of the partners in state P)

=> it is an inclusion / no deduction ➔ not dealt with

Reverse hybrid entity: internal income flow to the entity



If state P: T and state R: NT ➔ Reverse hybrid entity

=> state P doesn't tax income at the level of the entity

=> state R does recognize the deductible payment

➔ D/NI => art. 9, §2 Directive

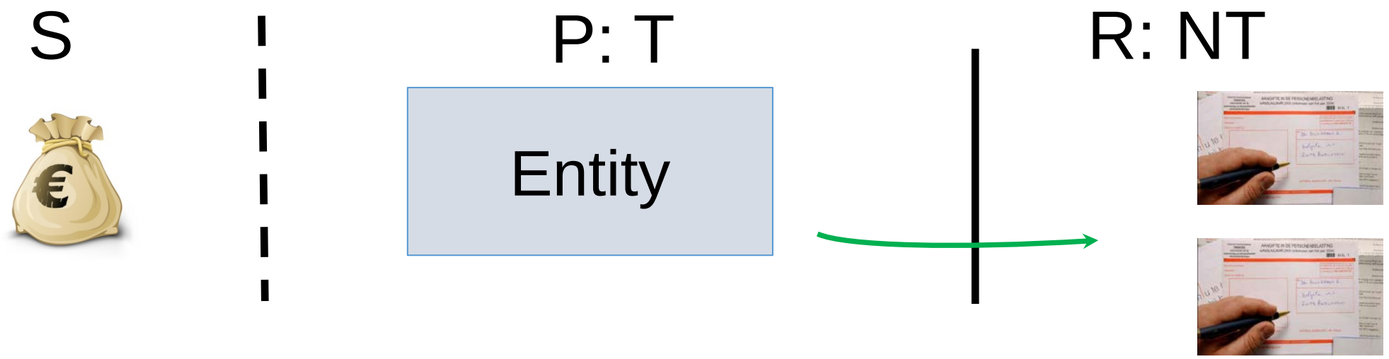
1. Refuse deduction

2. Include in tax base of EU-Member State,

unless deduction refused or income included by third state

(How to include in case of a lacking PE ???)

Reverse hybrid entity: internal income flow to the shareholder/partner



If state P: T and state R: NT ➔ Reverse hybrid entity

=> state P doesn't deduct payment at the level of the entity

=> state R does recognize the payment as taxable income

➔ Inclusion, without deduction => not dealt with

GENERAL SUMMARY

	Hybrid entity	Reverse hybrid entity
‘External’ payment to entity	Not foreseen	D/NI (art. 9, §2), but which state ??
‘External’ payment from entity	DD (art. 9, §1)	Not foreseen
‘Internal’ payment to entity	Not foreseen	D/NI (art. 9, §2), but how ??
‘Internal’ payment from entity	D/NI (art. 9, §2)	Not foreseen

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IMPORTING MISMATCH (D/D) FROM THIRD COUNTRIES

– **External D/D Conflict**:

Resident of member state provides the non-dual inclusion income against which the deduction is realised

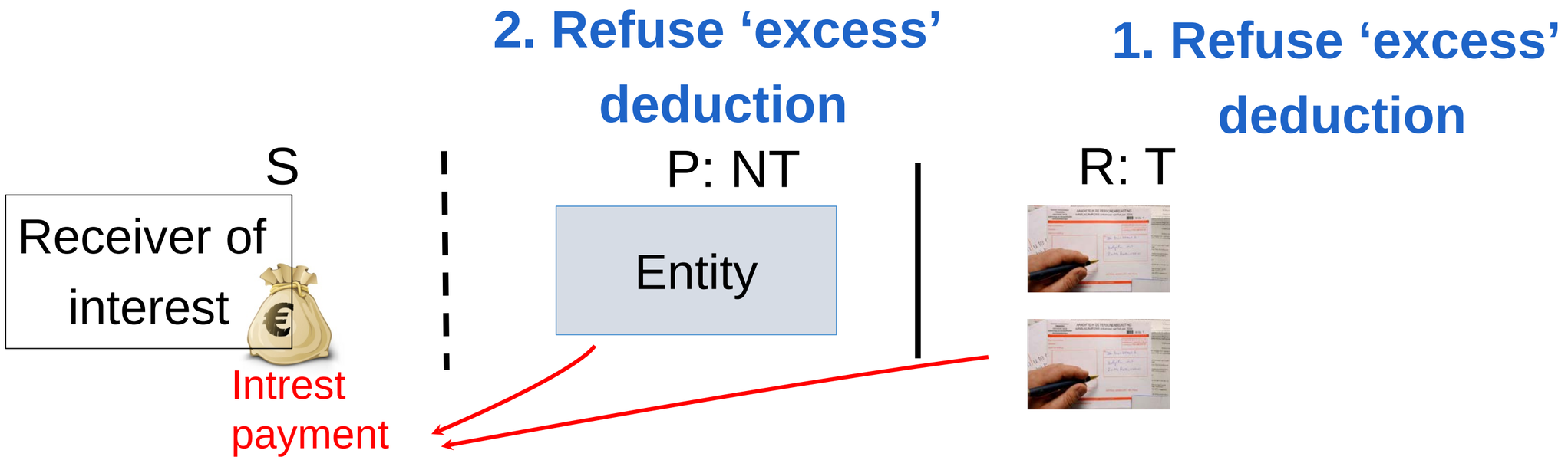
=> *Primary rule*: only deduction in source state of payment

Defensive rule: refusing deduction in source state of payment

Extra additional rule: refusing deduction in Member State paying the non-dual inclusion income (art. 9, §4 Dir.)

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Hybrid entity: paying expenses



If state P: NT and state R: T ➔ Hybrid entity

=> states P and R deduct the interest payment from the taxable income

=> it is a DD in case the deduction is **not against dual inclusion income**

➔ <u>negative result</u> (primary attribution to di-income) from the payment, but some income is linked with entity in P, but not with partner in R

Hybrid entity: paying expenses

S

Receiver of interest



Intrest payment

P: NT

Entity 1

Entity 2

2. Refuse 'excess' deduction

R: T





1. Refuse 'excess' deduction

According to P income of 2 is attributed to Entity 1, but not according to R (Non dual inclusion income)

EU financing entity

3. Refuse deduction of payment Art. 9, §4 Dir

IMPORTING MISMATCH (D/NI) FROM THIRD COUNTRIES

– **External D/NI Conflict**:

Resident of member state provides the income against which the deduction is realised

=> *Primary rule*: refuse ‘excess’ deduction

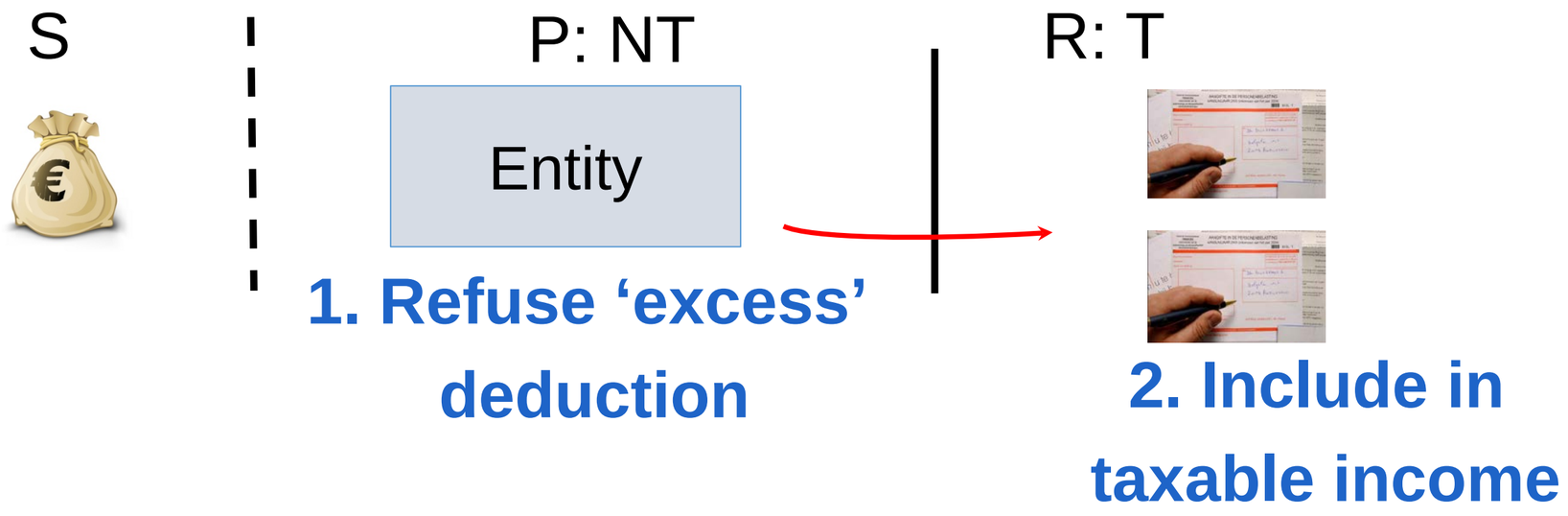
Defensive rule: include in taxable income of receiver

Extra additional rule: refusing deduction in Member State paying the non-dual inclusion income (art. 9, §5 Dir.)

“unless one of the third countries involved has already denied the deduction of the non-included payment”

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Hybrid entity: internal income flow to the shareholder/partner



If state P: NT and state R: T ➔ Hybrid entity

=> state P deducts payment at the level of the entity

=> state R does not recognize the payment

➔ Causes a D/NI conflict if deduction is against non dual inclusion income

Hybrid entity: internal income flow to the shareholder/partner

S

Receiver of interest



P: NT

1. Refuse 'excess' deduction

Entity 1

Entity 2

R: T

2. Include in taxable income





According to P income of 2 is attributed to Entity 1, but not according to R (Non dual inclusion income)

EU financing entity

3. Refuse deduction of payment Art. 9, §5 Dir

-Integration of a D/NI-conflict: refuse deduction in Member state

"unless one of the third countries involved has already denied the deduction of the non-included payment"

BUT: first solution is indeed refusing deduction

second solution is, however, including income in tax base

➔ so in that case it is no longer a 'non-included payment'

(but complex description, because a parallel was searched with art. 9, §4 Dir)

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CONCLUSION: HYBRID ENTITIES

-8 basic conflicts in mismatches

=> only dealing with 4 cases, focusing on the fight against tax avoidance, based on 2 possible conflicts (DD and D/NI)

-extension of solutions for ‘imported mismatches’

=> entity of Member state provides the ‘non dual inclusion income’ against which a deduction is applied:

refusing deduction as a 3th solution

=> Exciting to follow how it will be implemented !!

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Any questions / commentaries ?

Thank you for your attention !!

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