The Impact of ATAD 2 (Hybrid Mismatch Rules) on Private Equity Investments

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On 8 August 2019, the Luxembourg legislator released the draft law implementing EU Directive 2017/952 of 29 May 2017 (the “Anti-Tax Avoidance Directive 2” or “ATAD 2”) which provides for a comprehensive framework to tackle hybrid mismatch arrangements in an EU context and in transactions involving third States. This article analyses the scope, limits and mechanism of the new hybrid mismatches rules and considers their potential impact on private equity investments in Luxembourg.

1. Introduction

Hybrid mismatches typically result from a different tax treatment of an entity, a permanent establishment or a financial instrument under the laws of two or more jurisdictions and may give rise to double non-taxation (including long-term tax deferrals).

The new hybrid mismatch rules target a variety of different situations including direct hybrid mismatches between associated enterprises, structured arrangements between third parties, imported hybrid mismatches and tax residency mismatches. Most of the hybrid mismatch rules are included in a new version of Article 168ter of the Luxembourg Income Tax Law¹ (“LITL”) which will enter into force on 1 January 2020.

While the primary objective of the hybrid mismatch rules is the elimination of double non-taxation, tax adjustments under the hybrid mismatch rules should likewise not result in economic double taxation. This is ensured through a number of carve-outs and limitations that discharge the application of the hybrid mismatch rules.

ATAD 2 follows the recommendations of the OECD in regard to Action 2 of the Base Erosion and Profit Shifting (“BEPS”) Project that aim at neutralising the effects of hybrid mismatch arrangements through the application of linking rules that align the tax treatment in two or more jurisdictions. ATAD 2 explicitly states that the explanations and examples in the Final Report on BEPS Action 2 may be a source of interpretation to the extent this guidance is consistent with the provisions of the Directive.²

2. Typical Private Equity Investments

Private equity investments are typically made via a Luxembourg or foreign fund vehicle (the “Fund”) and Luxembourg companies which acquire businesses. The Luxembourg investment platform of the fund may, for example, consist of a Luxembourg master holding company (“LuxMasterCo”) and separate Luxembourg companies (“LuxCo”) for the different investments. Individual investments are either made directly in the operational companies (“OpCos”) or via a local acquisition company (“BidCo”).

The target companies are generally financed by a mixture of equity and debt. Where debt funding is provided to subsidiaries, Luxembourg companies will generally finance such receivables by debt instruments (for example, shareholder loans). When investments are held via two or more Luxembourg companies, the funds

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¹ The new version of Article 168ter of the LITL will replace the existing hybrid mismatch rules which have been introduced as part of the 2019 tax reform implementing EU Directive 2016/1164 of 28 January 2016 (the “Anti-Tax Avoidance Directive” or “ATAD”).
² See recital 28 of ATAD 2.
granted in the form of debt to the target companies may be routed via one or more Luxembourg companies. Additional funding may be obtained from external sources (for example, banks). The participations owned by LuxMasterCo may be financed by a mix of equity and debt instruments (for example, convertible bonds).

The following chart depicts a typical Luxembourg private equity fund structure:

While interest income is taxable at the level of a Luxembourg company, interest expenses are generally deductible for Luxembourg tax purposes. However, a Luxembourg company that performs financing activities or merely on-lends funds has to realize an arm’s length remuneration that is consistent with the functional and risk profile of the company (i.e. finance company vs. financial intermediary). Should the hybrid mismatch rules apply, they may result in the (partial) non-deductibility of interest expenses which may significantly increase the company’s taxable income. It follows that the hybrid mismatch analysis should in particular focus on the financing activities.

Income derived by LuxMasterCo from qualifying participations (i.e. dividends, capital gains and liquidation proceeds) may benefit from the participation exemption regime if certain conditions are met. As interest (and other) expenses incurred in relation to
holding activities are generally not deductible for Luxembourg tax purposes, the hybrid mismatch rules should have a limited impact in this respect.\(^3\)

As far as it concerns Luxembourg funds, there should be limited room for the application of the hybrid mismatch rules. However, a Luxembourg investment fund established in the legal form of a partnership (for example, a special limited partnership) or in contractual form (i.e. *fonds commun de placement, FCP*) may be a hybrid entity if the fund is treated as opaque from the perspective of the investor jurisdiction(s). In these circumstances, interest expenses incurred at the level of LuxMasterCo may be (partially) non-deductible.

The following chart depicts a foreign fund with a Luxembourg investment platform:

Foreign private equity funds investing via Luxembourg are often established for US investors. Given the particularities of US tax law, those funds may in particular be at risk of being impacted by the hybrid mismatch rules. Here, the potential existence of hybrid financial instruments and hybrid entities needs to be carefully analysed.

\(^3\) The hybrid mismatch rules may only apply in regard to tax deductible payments. Thus, non-deductible payments may not trigger any tax adjustments under the hybrid mismatch rules.
3. Hybrid mismatch rules

3.1. Overview

The hybrid mismatch rules apply to all Luxembourg corporate taxpayers and aim at neutralising mismatch outcomes which comprise deductions without inclusion\(^4\) and double deductions\(^5,6\).

The comprehensive scope of the hybrid mismatch rules covers virtually every possible hybrid mismatch situation irrespective of whether these are intentional or not. In some cases, it is even possible that more than one category of hybrid mismatches has to be tested in regard to the same payment. However, in practice many of these hybrid mismatch situations should not occur in a fund context.

While it cannot be excluded that other hybrid mismatch situations may be relevant in practice, hybrid mismatches in a fund context should mainly concern:
- hybrid mismatches that result from payments under a financial instrument;
- hybrid mismatches that are a consequence of differences in the allocation of payments made to a hybrid entity; and
- hybrid mismatches that result from payments made by a hybrid entity to its owner.

However, in general, a mismatch outcome should not be treated as a hybrid mismatch within the meaning of Article 168ter of the LITL unless it arises between associated enterprises. In case of so-called structured arrangements\(^7\), however, even transactions between unrelated parties may come within the scope of the hybrid mismatch rules.\(^8\)

Article 168ter (3) No. 3 of the LITL further targets so-called imported hybrid mismatches that shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of EU Member States through the use of a non-hybrid instrument. Nevertheless, as far as investments in a fund are concerned, imported hybrid mismatches should not be a common phenomenon.

3.2. Related party test

3.2.1. Definition of associated enterprises

For the purposes of the hybrid mismatch rules, the term “associated enterprise” is defined as follows:

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\(^4\) Deductions without inclusion are defined as the deduction of a payment (or deemed payment between the head office and PE or between two or more PEs) in any jurisdiction in which that payment (or deemed payment) is treated as made (payer jurisdiction) without a corresponding inclusion for tax purposes of that payment (or deemed payment) in the payee jurisdiction. In this regard, the payee jurisdiction is any jurisdiction where that payment or deemed payment is received or treated as being received under the laws of any other jurisdiction; see Article 168ter (1) No. 6 of the LITL. If the payment is brought into account as ordinary income in at least one jurisdiction, then there will be no mismatch for the rule to apply.

\(^5\) Double deductions are defined as a deduction of the same payment, expenses or losses in the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered (payer jurisdiction) and in another jurisdiction (investor jurisdiction). In the case of a payment by a hybrid entity or a PE, the payer jurisdiction is the jurisdiction where the hybrid entity or PE is established or situated; see Article 168ter (1) No. 5 of the LITL.

\(^6\) Article 168ter (1) No. 3 of the LITL.

\(^7\) A “structured arrangement” means an arrangement involving a hybrid mismatch where the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch; Article 168ter (1) No. 16 of the LITL.

\(^8\) Article 168ter (2) of the LITL.
- an entity in which the taxpayer directly or indirectly holds a participation of at least 50 percent in terms of voting rights or capital ownership, or is entitled to receive at least 50 percent of an entity’s profit;
- an individual or an entity that directly or indirectly holds a participation in the Luxembourg corporate taxpayer of at least 50 percent in terms of voting rights or capital ownership, or is entitled to receive at least 50 percent of the taxpayer’s profits;
- an entity that is part of the same consolidated group for financial accounting purposes (i.e. a group consisting of all entities which are fully included in consolidated financial statements drawn up in accordance with the International Financial Reporting Standards (IFRS) or the national financial reporting system of an EU Member state); or
- an entity in which the taxpayer has a significant influence in the management or an entity that has a significant influence in the management of the taxpayer.\(^9\)

Where an individual or an entity that directly or indirectly holds a participation of at least 50 percent in terms of voting rights or capital ownership in the taxpayer and one or several other entities, all these entities including the taxpayer are considered as associated enterprises within the meaning of Article 168ter of the LITL.\(^10\)

With regard to hybrid mismatches involving hybrid financial instruments\(^11\) the threshold requirement of 50 percent is reduced to 25 percent.\(^12\)

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

### 3.2.2. Aggregation of interests

In certain circumstances, the shareholding percentages of otherwise unrelated parties should be aggregated for the purposes of the related party test. More precisely, a person who acts together with another person in respect of voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other person.\(^13\)

The purpose of the “acting together” concept is to prevent taxpayers from avoiding the related party test being met by transferring their voting interest or equity interest to another person who continues to act under their direction in relation to those interests. The other situation targeted by the acting together concept is where a taxpayer or a group of taxpayers who individually hold minority stakes in an entity, enter into arrangements that would allow them to act together (or under the direction of a single controlling mind) to enter into a hybrid mismatch arrangement with respect to one of them.\(^14\)

The concept of acting together may in principle also apply in a fund context. However, according to the commentaries to the draft law, investors in a fund generally do not have effective control over the investments made by the fund that has to invest the contributions of investors in accordance with the fund’s investment policy. Therefore, the draft law provides for a safe harbour rule according to which an investor (be it an individual or an entity) that owns directly or indirectly less than 10

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\(^9\) Article 168ter (1) No. 17 of the LITL
\(^10\) Article 168ter (1) No. 17 of the LITL
\(^11\) Article 168ter (1) No. 2 a) of the LITL
\(^12\) Article 168ter (1) No. 17 of the LITL
percent of the shares or units in a fund (and that is entitled to less than 10 percent of
the fund’s profits) is considered not to act together with the other investors, unless
proven otherwise. Here, the burden of proof would be on the Luxembourg tax
authorities to evidence that investors are acting together within the meaning of this
concept.

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

3.3. Tax treatment of hybrid mismatches

Article 168ter of the LITL aims at neutralising the effects of hybrid mismatches
through the introduction of linking rules that align the tax treatment of an instrument
or an entity with the tax treatment in the counterparty jurisdiction.

More precisely, Article 168ter (3) of the LITL sets out a primary rule and a secondary
(or defensive) rule for the neutralisation of mismatch outcomes. This mechanism
should prevent that more than one country applies the hybrid mismatch rules to the
same arrangement and avoid double taxation.

According to the primary rule, the deduction of a payment is denied to the extent that
it is not included in the taxable income of the recipient or is also deductible in the
counterparty jurisdiction. When the primary rule is not applied, the counterparty
jurisdiction may apply a defensive rule, requiring the deductible payment to be
included in the income or denying the duplicate deduction depending on the nature of
the mismatch.

When a hybrid mismatch involves a third state, ATAD 2 places the responsibility to
neutralise the effects of hybrid mismatches, including imported hybrid mismatches,
on the EU Member States.

However, when the hybrid mismatch rules apply, the adjustment should be no more
than what is necessary to neutralise the mismatch outcome. Thus, when a hybrid
mismatch concerns only part of the investors, the amount of the deduction that is
denied should generally be limited to the part of the payment that is attributable to
such investors.

4. Limits of the hybrid mismatch rules

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

15 Article 168ter (1) No. 17 of the LITL.
16 This should avoid economic double taxation; see, for example, Final Report on BEPS Action 2, p. 59, No. 155; p. 72, No. 200.
17 See Final Report on BEPS Action 2, p. 31, No. 43.
18 See, for example, Final Report on BEPS Action 2, p. 29, No. 36 and p. 86, No. 245.
• **Deductible payments**

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

• **Timing differences**

Jurisdictions may use different tax periods and have different rules for recognising when items of income or expenditure have been derived or incurred. However, timing differences should generally not be treated as giving rise to mismatches in tax outcomes as long as the income is included within a reasonable period of time.\textsuperscript{19}

A payment under a financial instrument is deemed to be included within a reasonable period of time if such payment is included by the payee within 12 months of the end of the payer’s tax period.\textsuperscript{20} Alternatively, it has to be evidenced by the taxpayer that it is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future tax period and the terms of payment adhere to the arm’s length principle.

• **ATAD 2 and the effect of other EU Directives**

Where the provisions of another EU Directive, such as the Parent-Subsidiary Directive\textsuperscript{21}, lead already to the neutralisation of the mismatch in tax outcomes, there should be no scope for the application of the hybrid mismatch rules.\textsuperscript{22}

Under Article 166 of the LITL (that is the domestic implementation of the Parent-Subsidiary Directive, as amended), a dividend payment only benefits from the participation exemption regime if the payment was not deductible at the level of the distributing EU subsidiary. Similar provisions should be included in the tax laws of all EU Member States and take precedence over the hybrid mismatch rules.\textsuperscript{23}

• **Inclusion of income**

A deduction without inclusion outcome assumes that a deductible payment is not included in any jurisdiction where that payment (or deemed payment) is received (or is treated as being received) under the laws of any other jurisdiction.\textsuperscript{24}

On the contrary, no mismatch outcome exists if the payment is included in the taxable income in at least one jurisdiction. Thus, the inclusion in any jurisdiction is sufficient to discharge the application of the hybrid mismatch rules.\textsuperscript{25} Likewise, income is deemed to be included where CFC rules have the effect of including a payment in the ordinary income of an investor.\textsuperscript{26}

\textsuperscript{19} See recital 22 of ATAD 2.
\textsuperscript{20} Article 168ter (1) No. 2 a) of the LITL.
\textsuperscript{21} Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (as amended).
\textsuperscript{22} See recital 30 of ATAD 2.
\textsuperscript{23} Article 166 (2bis) of the LITL.
\textsuperscript{24} Article 168ter (1) No. 6 of the LITL.
\textsuperscript{25} See Final Report on BEPS Action 2, p. 41, No. 89; p. 57, No. 149.
\textsuperscript{26} See Final Report on BEPS Action 2, p. 57, No. 150.
• Tax status of the payee

A payment should not be treated as giving rise to a hybrid mismatch if the non-inclusion of a payment would have arisen in any event due to the tax status of the payee under the laws of the payee jurisdiction. Accordingly, the following payments should be deemed not to give rise to a deduction without inclusion outcome:

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

Furthermore, as regards financial instruments, a payment should not be considered as giving rise to a mismatch outcome that is due to the fact that the instrument is held subject to the terms of a special regime.27

• Dual inclusion income

With regard payments by a hybrid entity28, deemed payments between a head office and a PE29 and double deductions30, the hybrid mismatch rules only apply if and to the extent a deduction is set-off against income that is not dual inclusion income (that is any item of income that is included under the laws of both jurisdictions where the mismatch outcome arises). Thus, the deduction of payments from dual-inclusion income does not trigger the application of the hybrid mismatch rules.

• Transfer pricing adjustments

Differences in tax outcomes that are solely attributable to transfer pricing adjustments do not fall within the scope of the hybrid mismatch rules. Therefore, downward adjustments that are treated as deductible expenses by a taxpayer should not trigger the application of the hybrid mismatch rules even if no corresponding transfer pricing adjustment is made in the other jurisdiction.31

• Allocation of taxing rights under tax treaties

Any adjustment required under the hybrid mismatch rules should in principle not affect the allocation of taxing rights between jurisdictions laid down under a tax treaty, confirming that tax treaty law is generally superior to the domestic tax laws of the Contracting States.32

5. Cooperation duties of the taxpayer

According to Article 168ter (6) of the LITL, the taxpayer has the burden of proof that the hybrid mismatch rules are not applicable in a given case. This means that

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27 See Final Report on BEPS Action 2, p. 43, No. 96; see recital 16, 18 and 20 of ATAD 2.
28 Article 168ter (1) No. 2 e) of the LITL.
29 Article 168ter (1) No. 2 f) of the LITL.
30 Article 168ter (1) No. 2 g) of the LITL.
31 See recital 22 of ATAD 2, see Final Report on BEPS Action 2, p. 33, No. 53.
32 See recital 11 of ATAD 2.
taxpayers have, upon request, to provide the tax authorities with comprehensive, objective and verifiable information and documentation such as a statement of the issuer of a financial instrument, a foreign tax return, a tax certificate or any other document issued by foreign tax authorities in order to demonstrate that the hybrid mismatch rules provided under Article 168ter (3) – (5) of the LITL are not applicable.

Although Article 168ter (6) of the LITL does not require taxpayers to proactively provide comprehensive evidence when filing their corporate tax returns (but only upon request), the potentially severe consequences of Article 168ter of the LITL will pressure taxpayers to review their existing investments and include a hybrid mismatch analysis in each and every future tax analysis. After all, taxpayer cannot wait to find out about a potential hybrid mismatch situation upon an investigation by the Luxembourg tax authorities that may span over several years.

6. Conclusion

As from 1 January 2020, the Luxembourg legislator implements the comprehensive hybrid mismatch rules provided under ATAD 2. The new rules are characterised by an extreme complexity which requires a good understanding of the overall investment structure and the foreign tax treatment of payments, entities, financial instruments, etc. However, as far as Private Equity Funds are concerned, it should generally be possible to focus on certain types of hybrid mismatch situations.

Overall, the Luxembourg legislator made the right choices when adopting ATAD 2, avoiding unintentional collateral damage for the Luxembourg fund industry. Nevertheless, the interpretation of some of the many intricate concepts and rules included in the hybrid mismatch rules needs to be further clarified in order to ensure a consistent application in practice.

With few months left in 2019 before the new hybrid mismatch rules will enter into force, taxpayers have to analyse existing investment structures in order to detect potential hybrid mismatches and to implement, where necessary, structure alignments before 2020. Ultimately, the complexity of the hybrid mismatch rules may also be an opportunity to manage their impact in practice.

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