



Federale
Overheidsdienst
FINANCIËN

HYBRID MISMATCHES – IOTA MAY 2025

GENERAL INTRODUCTION

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HYBRID MISMATCHES

- OECD: BEPS Action 2
 - *“Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness”*



HYBRID MISMATCHES

- **Mismatch:**
 - Deduction/Non-Inclusion Outcome (D/NI): a payment or part of a payment that is treated as deductible under the laws of one jurisdiction is not included in ordinary income by any other jurisdiction.
 - Double Deduction Outcome (DD): all or part of the payment that is deductible under the laws of one jurisdiction is set-off against non-dual inclusion income in another jurisdiction
 - NOT:
 - Notional interest deductions for equity capital without requiring the taxpayer to make a payment (economically closer to a tax exemption) (BEPS Action 2 - 2015 Final Report Action 2 p. 17, § 11)
 - differences in the value ascribed to a payment (e.g. gains and losses from foreign currency fluctuations, or differences in value through the application of transfer pricing)
- **Hybrid element:**
 - The use of hybrid instruments, which generally involve a conflict in the characterization of the instrument
 - Transparency or opacity of an entity for tax purposes (hybrid entities)
 - Branch mismatches: the residence jurisdiction (head office) and a branch jurisdiction take a different view as to the allocation of income and expenditure between the branch and head office, or situations where the branch jurisdiction does not treat the taxpayer as having a taxable presence in that jurisdiction

HYBRID MISMATCHES

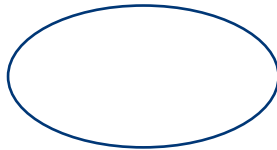
- Commonly used symbols



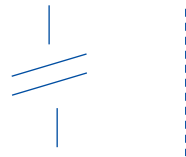
Opaque entity



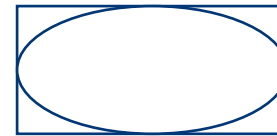
Partnership



Permanent establishment



Indirectly owned



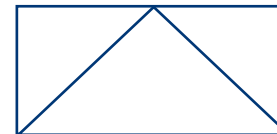
US check-the-box:

Transparent entity for US, it becomes a branch of the US parent entity (circle)
Opaque for home country (rectangle)



Reverse hybrid entity:

Transparent in home country (triangle)
Opaque in foreign jurisdiction (rectangle)



Hybrid entity:

Opaque in home country (rectangle)
Transparent in foreign jurisdiction (triangle)



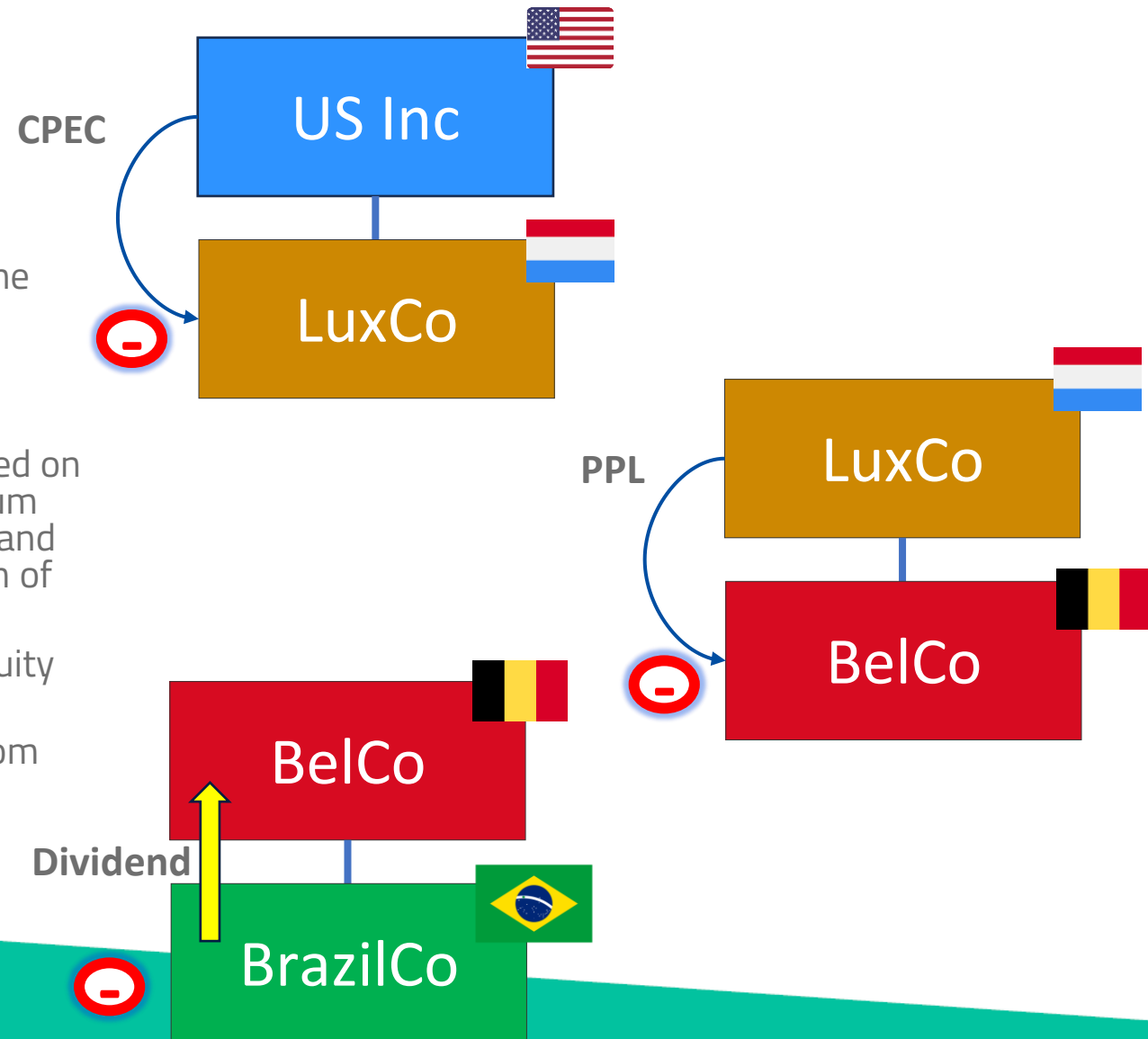
Loan/License

Arrow point from creditor/licensor to debtor/licensee

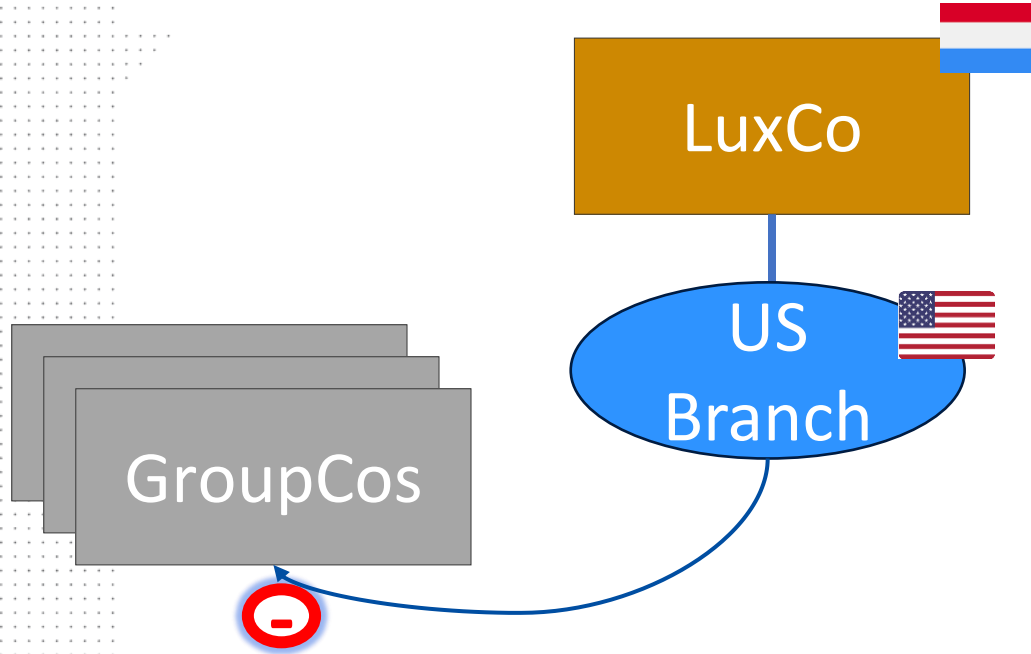
HYBRID MISMATCHES – REAL LIFE EXAMPLES

- Hybrid Financial Arrangement

- Preferred Equity Certificates (e.g. CPECs)
 - No taxation in the US as long as the interest is not paid out (accrued).
 - Deductible in Luxembourg
- Profit Participation Loan
 - Variable interest component (based on profit debtor). E.g. between Belgium (very broad definition of interest) and Luxembourg (very broad definition of dividends)
- Brazilian interest payments on net equity (Juros sobre o capital próprio):
 - Dividend is (partially) deducted from profit Brazilian company
- Result: D/NI



HYBRID MISMATCHES – REAL LIFE EXAMPLES

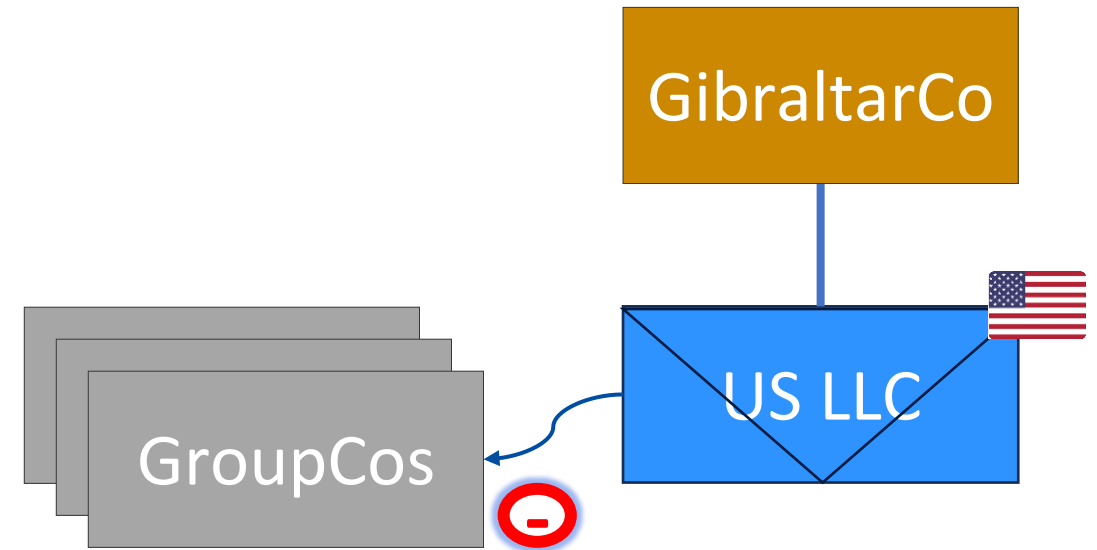


- Branch mismatch arrangements - US Finance Branch
 - From Lux perspective: Permanent Establishment under the US-Lux treaty → taxing rights US
 - From US perspective: no activities (no *"trade or business"*) → no taxable presence under domestic law
 - Similar structures existed with Irish non-trading branches
 - See also McDonald's State Aid case (SA.38945)
 - Result: D/NI

HYBRID MISMATCHES – REAL LIFE EXAMPLES

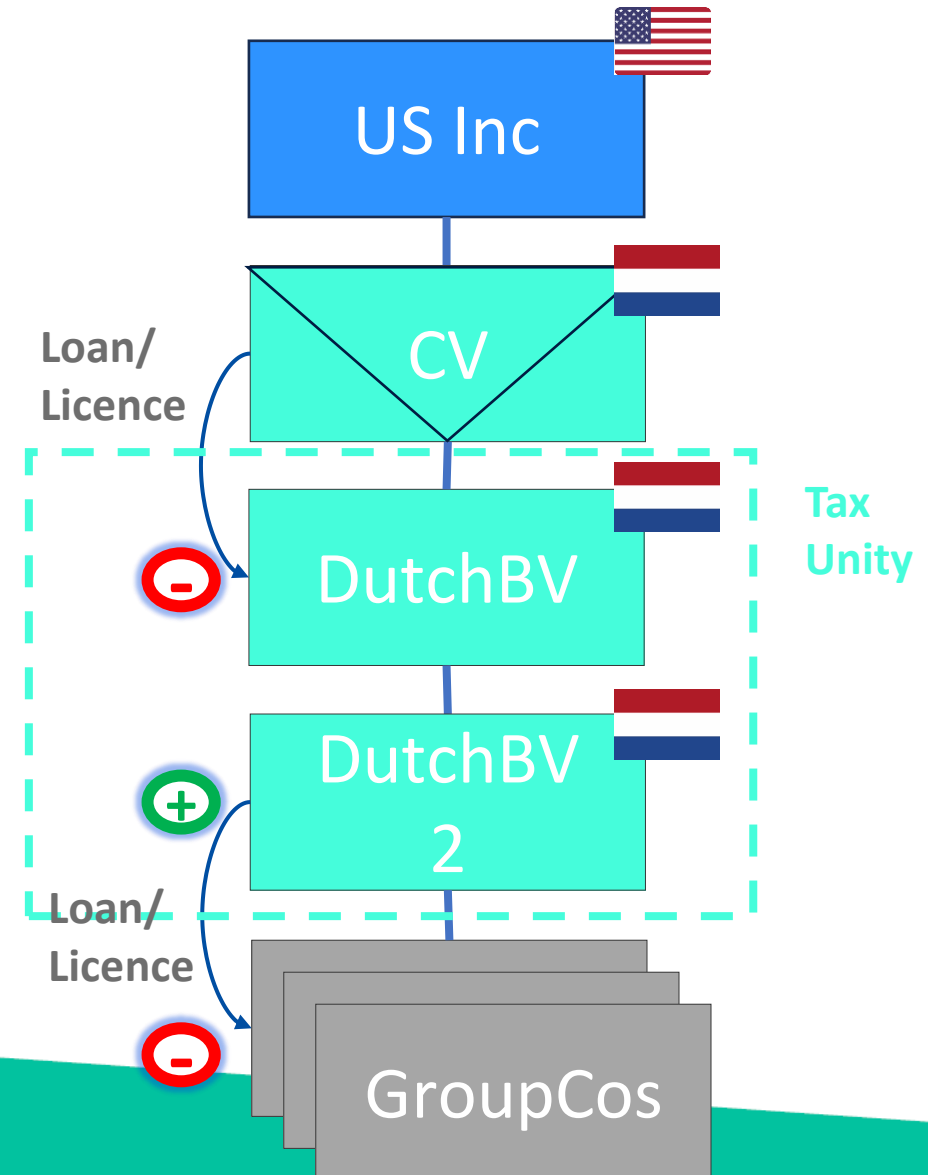
- **Reverse Hybrid Entity**

- A “reverse hybrid” is an entity that is fiscally transparent in the jurisdiction where it is organized but opaque under the tax laws of an investor
- US LLC
 - Tax transparent from US perspective → income is attributed to the shareholders/partners
 - For several jurisdictions, a US LLC is treated as a separate legal entity → income is attributed to the LLC
 - Result: D/NI

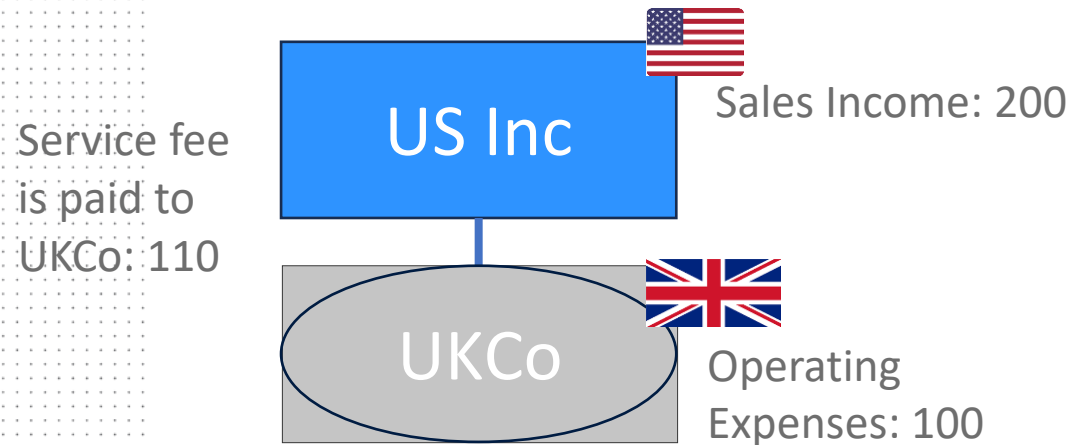


HYBRID MISMATCHES – REAL LIFE EXAMPLES

- **Reverse Hybrid Entity**
 - CV-BV structure
 - CV = Hybrid entity
 - BV = Required for withholding tax exemption in source state
 - (BV 2 = to avoid obvious back to back)
 - Used for royalties / interest
 - From US perspective: CV is a separate taxable person → taxing rights in NL
 - From NL perspective: CV is transparent → taxing rights in the US
 - D/Nl at level of DutchBV
 - Imported mismatch at the level of GroupCos



HYBRID MISMATCHES – REAL LIFE EXAMPLES



- **Double deduction – US check the box rules**
 - Potential double deduction of operating expenses (US and UK)
 - No dual inclusion income (sales income only recorded at the level of US Inc, service fee is not dual inclusion income).
 - Application of general rules → deny deduction in UK
 - (legislation has been amended in the UK in 2020)



HYBRID MISMATCHES

- OECD

- 1999: The Application of the OECD Model Tax Convention to Partnerships
- 2012: Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues
- 2013: Addressing Base Erosion and Profit Shifting (identifying Hybrid Mismatches as a separate action)
- 2015: BEPS Action 2 – recommendations on hybrid entities, hybrid payments and hybrid financial instruments
- 2017: BEPS Action 2 – recommendations on hybrid mismatches involving a branch



HYBRID MISMATCHES

- EU:
 - Code of Conduct for Business Taxation (soft law – as of 1998)
 - 2014: amendment to the parent-subsidiary directive, on hybrid payments
 - 2016: ATAD 1 (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)
 - Art 9: basic rules on hybrid entities, hybrid payments and hybrid financial instruments
 - 2017: ATAD 2 (Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries)
 - Amendment to ATAD 1: replaces art 9 ATAD 1 by a comprehensive set of rules inspired by the 2 OECD reports



HYBRID MISMATCHES

- The OECD Action 2 report includes a whole list of recommendations, aimed at changes to:
 - Domestic law; and
 - Changes to the tax treaty (which has materialized via the MLI)
- Rules are highly complex, and target a wide variety of structures (report 500+ pages)
- Main focus on transactions within international groups, but also structured arrangements are targeted
 - A structured arrangement is any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch
- In order to avoid the risk of double taxation, Action 2 also calls for “guidance on the co-ordination or tie-breaker rules where more than one country seeks to apply such rules to a transaction or structure”



HYBRID MISMATCHES

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
D/NI	Hybrid financial instrument	No dividend exemption for deductible payments Proportionate limitation of withholding tax credits	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
	Disregarded payment made by a hybrid		Deny payer deduction	Include as ordinary income	Control group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque	Deny payer deduction	-	Control group and structured arrangements
DD	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response, defensive rule applies to control group and structured arrangements
	Deductible payment made by dual resident		Deny resident deduction	-	No limitation on response
Indirect D/NI	Imported mismatch arrangements		Deny payer deduction	-	Members of control group and structured arrangements



HYBRID MISMATCHES

- **Imported mismatches rule:**
 - The effect of a foreign hybrid mismatch (that is not neutralised in the respective jurisdiction(s)) is shifted into the domestic jurisdiction using a non-hybrid instrument such as an ordinary loan
 - Income from an imported mismatch payment is set-off, directly or indirectly, against a deduction that arises under a hybrid mismatch arrangement in a foreign jurisdiction.
 - “Imported mismatch payment” covers a broad range of payments (interest, royalties, rents, payments for services), but will “not generally” include “considerations for the disposal of an asset” (Action 2 – 2015 Final Report, § 242)
- Three types of “imported” mismatches:
 - (a) **Structured imported mismatch:** hybrid deduction under a structured arrangement funded by an imported mismatch payment, to the extent that the latter payment is set-off by the hybrid deduction
 - (b) **Direct imported mismatch:** apportionment approach that compares the amount of the taxpayer’s (indirect) hybrid deductions to the total amount of imported mismatch payments made to that taxpayer by group entities and treats each imported mismatch payment as being set-off against those hybrid deductions in accordance with that ratio
 - (c) **Indirect imported mismatch:** covers any “surplus” hybrid mismatch that is not yet neutralized as structured or direct imported mismatch, e.g. the effect of a mismatch is indirectly transferred via a tax unity (cfr. Belgian case) or a chain of tax-deductible payments (potentially very broad scope)



HYBRID MISMATCHES

- Entry into force in most EU countries as of 2019/2020 (2022 for reverse hybrid mismatches)
- However, OECD Action 2 Report also targets 2017 and 2018 in the case of **carried forward losses** (see § 263):
 - In order to account for timing differences between jurisdictions and to prevent groups manipulating that timing in order to avoid the effect of the imported mismatch rule, **a hybrid deduction should be taken to include any net loss that has been carried-forward to a subsequent accounting period**, to the extent that loss results from a hybrid deduction.
 - In order to reduce the complexity associated with the need to identify hybrid deductions that arose prior to the publication of this report any carry-forward loss from periods ending on or before 31 December 2016, should be excluded from the operation of this rule.



HYBRID MISMATCHES

- **Specific recommendations for the tax treatment of financial instruments:**
 - Denial of dividend exemption for deductible payments
 - In order to prevent duplication of tax credits under a hybrid transfer, any jurisdiction that grants relief for tax withheld at 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.
- **Dual-resident payer rule**
 - Each resident jurisdiction will deny a deduction for such payment to the extent it gives rise to a DD outcome.
 - No mismatch will arise to the extent that the deduction is set-off against income that is included as income under the laws of both jurisdictions (i.e. dual inclusion income).



HYBRID MISMATCHES

- MNEs have amended their strategies, which significant changes (mainly in 2018). Often new strategies have been put in place, involving low taxed jurisdictions, or countries with notional interest deduction regimes (which has been explicitly recognized as not constituting a hybrid mismatch).
- Difficult to detect these mismatches. Imported mismatches require an understanding of (at least) two separate foreign tax regimes. But it seems that some countries have developed new mechanisms:
 - *A Swiss tax regime that was introduced following the 2019 abolition of the Swiss “principal company regime” and that allows Swiss companies to amortize, as from 1 January 2020 for federal tax purposes, the step-up of the goodwill that is considered to be recognized upon the “repatriation” of a deemed permanent establishment (PE) – Targeted by Italian Tax Authorities*
<https://www.taxathand.com/article/29790/Italy/2023/Ruling-issued-regarding-application-of-imported-hybrid-mismatch-rule>)
- Interplay with US tax rules (entity classification – disregarded entities)?



HYBRID MISMATCHES

- Also in Belgium, the main impact seems to be that existing hybrid structures have been unwound
- Mainly disallowed expenses, limited amount / limited number of taxpayers (and not all reported payments seem to be considered a hybrid mismatch...)

Hybrid Mismatches	Biz_1236	Biz_1237	Biz_1486
AJ 2022 - aantal ondernemingen	16	0	0
AJ 2023 - aantal ondernemingen	19	1	0
AJ 2022 - totaalbedrag in euro	774.878,49	0	0
AJ 2023 - totaalbedrag in euro	805.151,67	2.485,22	0



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