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NOTE

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Subject:	Proposal for a Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (ATAD 2) – Explanation of Changes to Article 9(4)(b) and (c)

Delegations will find in the Annex the room document #2 that was distributed electronically on 5 December 2016 in view of the ECOFIN meeting on 6 December 2016.

ANNEX

EXPLANATION OF CHANGES TO ARTICLE 9(4)(B) AND (C)

On 2 December, the Presidency put forward a compromise text for a Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (ATAD 2). The Presidency also released a Working Paper explaining the text of the Presidency Compromise.

Since that date there have been a number of bilateral discussions between Member States regarding the exclusions to the hybrid mismatch rules set out in (revised) Article 9(4) of ATAD 2.

As a result of these discussions the Presidency puts forward suggested revisions to Articles 9(4)(b) and (c). These changes are intended to narrow the scope of these exemptions in those paragraphs so that they more accurately target the policy behind each exclusion and reduce the risk of a mismatch arising. It is to be noted that the exclusions in Article 9(4) are at the option of Member States, so that where a Member State chooses not to apply the directive to neutralise a hybrid mismatch this does not affect another Member State's choice of whether to apply the hybrid mismatch rules in respect of the same fact pattern.

Set out below is a brief explanation of the proposed amendments to Article 9(4)(b) and (c).

Changes to Article 9(4)(b)

Paragraphs 19-23 of the Working Paper explain the issues arising from a potential interaction between the hybrid financial instrument rules in ATAD 2 and the rules governing the allocation of intra-group regulatory capital within banking and insurance groups.

In order to strike a reasonable balance between these competing international tax and regulatory concerns the compromise text allows banking and insurance groups to continue to meet the capital requirements imposed on them by regulators through the issuance of intra-group regulatory capital, while minimising the opportunities to create mismatches through the use of these instruments.

The revised Article 9(4)(b) provides Member States with 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, but only where that instrument has been issued with the sole purpose of satisfying regulatory capital requirements, and not for the purpose of obtaining a tax advantage.

The exclusion is limited to the amount of capital that has been issued to satisfy applicable regulatory requirements and that is connected to external issuance of regulatory capital instruments at the level of the ultimate parent. This exclusion imposes two important restrictions on the amount of the intra-group regulatory capital that qualifies for the exclusion: the first operates at the level of the issuer, by limiting the exclusion to the amount of regulatory capital as required under local law, and the second operates at the parent level, ensuring that the intra-group capital that qualifies for the exclusion is connected to an actual issue of regulatory capital by the ultimate parent of the group.

The revised text proposed is as follows:

(b) Article 9(2)(a) and (b) hybrid mismatches resulting from a payment of interest ~~to the holder of~~ **under** ~~the hybrid~~ **a financial instrument** ~~capital securities~~ **to an associated enterprise where:**

(i) the financial instrument has conversion, bail-in or write down features;

(ii) the financial instrument has been issued with the sole purpose of satisfying regulatory capital requirements applicable to the banking and insurance sector;

(iii) the financial instrument has not been issued for the purpose of obtaining a tax advantage; and

(iv) the issuance does not exceed a level necessary to satisfy applicable regulatory requirements and is connected to financial instruments with conversion, bail-in and write-down features at the level of the ultimate parent undertaking.

The revised text is significantly narrower than that set out in the current Presidency compromise in that it limits the scope of the exclusion to regulatory capital that has been issued solely for the purposes of complying with regulatory requirements (and not for the purposes of avoiding taxes). The language contains safeguards for protecting the tax base of the issuer in that the amount that qualifies for the exclusion is limited by local law regulatory requirements and capped by reference to the amount of capital that has been raised by the parent and pushed down to the local entity.

This text would be accompanied by the following recital

(16a) In order to avoid unintended outcomes in the interaction between the hybrid financial instrument rule and the capital requirements imposed on banks, insurance companies and other regulated entities, the directive provides that Member States may exclude from the scope of the directive, instruments that have been issued intra-group with the sole purpose of meeting the issuer's regulatory capital requirements and not for the purposes of avoiding tax. This exclusion should apply only to the amount of regulatory capital that has been issued in order to meet regulatory requirements and that is connected to regulatory capital instruments issued by ultimate parent to the market.

Changes to Article 9(4)(c)

Paragraphs 24-27 of the Working Paper identify the issues that could arise from the application of the hybrid financial instrument rule to a financial trader. As described in the Working Paper the hybrid financial instrument rule adjusts the tax consequences of a payment under a financial instrument when the mismatch is attributable to a difference in the characterisation of the instrument or the payment made under it. The adjustment that is made under the hybrid financial instrument rule is only to the extent of such mismatch and should not impact on deductions or exemptions that are solely a consequence of the status of the taxpayer rather than the tax treatment of the instrument.

Nevertheless, there are some concerns that the Directive could have an unintended and negative impact on securities lending markets. Securities lending is important for maintaining market liquidity. Securities lending is generally a high volume / low margin business where trading is either on-market or conducted through nominees making it impossible for a market participant to know the identity or tax residency of the counterparty to a particular trade. Some Member States are concerned that the hybrid financial instrument rule (which would deny the deduction under a share loan or repo based on the tax treatment of the arrangement in the counterparty jurisdiction) could impose an unacceptable and uncontrollable tax risk on market participants with negative consequences for liquidity in this market. Some Member States also point out that payment made by a financial trader under a share lending or repo transaction generally raises little tax risk, as the financial trader will be subject to taxation on the net income under the arrangement (including tax on the underlying return on the borrowed instrument).

Accordingly, the Presidency proposes a compromise text that is intended to provide a narrow carve-out for financial traders in this situation. The carve-out applies only where:

- a payment is made by a financial trader under a hybrid transfer;
- the hybrid transfer has been entered into in the ordinary course of a business of borrowing or lending securities;
- the financial trader will be taxable on any income it receives under the same hybrid transfer arrangement; and
- the payment is not part of a structured arrangement.

The revised text is as follows:

(c) Article 9(2)(a) and (b) hybrid mismatches resulting from a payment made by a financial trader under a hybrid transfer **that is entered into in the ordinary course of a business of borrowing or lending securities provided that:**

(i) the payment is not made as part of a structured arrangement; and

(ii) the income that the financial trader receives under the hybrid transfer is included.

The revised text is significantly narrower than that set out in the current Presidency compromise in that it limits the scope of the exclusion to hybrid transfers that are entered into in the ordinary course of a trading business. The language guards against any potential tax loss by ensuring that it only applies where the financial trader will be subject to tax on the underlying return from the securities and that the exclusion will not apply where the arrangement has been structured to produce a mismatch in tax outcomes.

If desirable, the term "financial trader" could be defined further as follows:

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.

This text would be accompanied by the following recital

(16b) In order to avoid unintended impacts in respect of the securities lending market the directive provides that Member States may exclude from the scope of the directive, a payment that is made by a financial trader under a hybrid transfer where that hybrid transfer has been entered into in the ordinary course of a business of borrowing or lending securities. This exclusion will not apply, however, unless the financial trader is taxable on any income it receives under the same hybrid transfer arrangement or where the payment is made under a structured arrangement.