Guidance on the anti-hybrid rules

Part 35C-00-01

This document should be read in conjunction with Part 35C of the Taxes Consolidation Act 1997

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Revenue
Cáin agus Custaim na hÉireann
Irish Tax and Customs

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Executive Summary

This manual provides an overview of the anti-hybrid rules that were introduced into Part 35C TCA 1997 by Finance Act 2019. It sets out information in relation to:

1. What is meant by a mismatch outcome, being a double deduction mismatch outcome or a deduction without inclusion mismatch outcome, and the specific situations that give rise to a hybrid mismatch outcome.
2. The test for inclusion. What is meant by the term "corresponding amount" and how to test whether a corresponding amount has been included for the purposes of the anti-hybrid rules in various scenarios.
3. How the anti-hybrid rules interact with Ireland's worldwide system of taxation and how the rules interact with an effective worldwide system of taxation such as the US check-the-box system of taxation.
4. What provisions are regarded as having similar effect to the anti-hybrid rules, a non-exhaustive list is provided.

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1 Introduction to hybrid mismatches

Part 35C Hybrid mismatches implements the Anti-Tax-Avoidance Directives, specifically Council Directive (EU) 2017/952 of 29 May 2017 (ATAD2) amending Directive (EU) 2016/1164 (ATAD) by introducing anti-hybrid rules.

The purpose of anti-hybrid rules is to prevent arrangements that exploit the differences in the tax treatment of an instrument or entity arising from the way in which that instrument or entity is characterised under the tax laws of two or more territories to generate a tax advantage or a mismatch outcome. Essentially a hybrid-mismatch outcome arises due to differences in the tax characterisation, or to the hybrid nature of, the instrument or entity. ATAD2 specifically provides that:

(i) a mismatch outcome shall not arise where the payee is exempt from tax in the territory in which it is established[1], and

(ii) that the anti-hybrid rules should not affect the general features of the tax system of a Member State[2].

The OECD BEPS Action 2 report clearly sets out in para. 13 that "**while cross-border mismatches arise in other contexts…the only types of mismatches targeted by this report are those that rely on a hybrid element to produce such outcomes.**" As such, the purpose of the anti-hybrid rules is to address mismatches that arise due to the character and tax treatment of a payment and not because of the status of the payee or special tax regimes.

The anti-hybrid rules apply to all corporate taxpayers; there is no **de minimis** threshold below which the rules do not relate, and the rules apply to all payments made after 1 January 2020[3].

The rules are complex, specifically as they apply to cross border transactions and require consideration of the tax treatment of transactions / entities in other territories. The rules, therefore, include many new concepts and definitions that must be applied in a cross-border context.

Given the complexities of the rules in their application to various cross-border corporate transactions and structures, ATAD2 specifically states[4] that "*Member States should use the applicable explanations and examples in the OECD BEPS report on Action 2 as a source of illustration or interpretation to the extent that they are consistent with the provisions of the Directive and with Union Law*". It is therefore recommended that corporate taxpayers within the scope of the anti-hybrid rules refer to the explanations and examples contained in that report when considering the application of the rules in Part 35C to relevant transactions.

This manual is designed to provide the user with guidance as to the various concepts that arise in the anti-hybrid rules. This manual does not provide guidance on the Action 2 report, nor does it repeat any of the guidance given in that report: it focuses solely on the aspects of the Irish legislation not covered by that report. Given the complexity of the rules, the manual is being published chapter by chapter as each chapter is completed. The schedule of updates is tracked in Appendix I.

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2 Mismatch outcomes

The anti-hybrid rules seek to address mismatch outcomes that arise in specific situations due to the hybrid nature of an entity or a financial instrument. The OECD BEPS Report on Action 2 (Neutralising the effects of hybrid mismatch arrangements) states[5] "**while cross-border mismatches arise in other contexts the only types of mismatches targeted by this report are those that rely on a hybrid element to produce such outcomes**". Essentially the rules seek to address international tax planning based around hybridity that gives rise to non-taxation via base erosion. ATAD[6] defines a mismatch outcome to mean a double deduction or a deduction without inclusion, and this is mirrored in the definition of mismatch outcome contained in section 835Z(1).

2.1 Double deduction mismatch outcome (D/D)

A double deduction mismatch outcome arises to the extent a payment or part of a payment is tax deductible in two territories against non-dual inclusion income. Put another way, in general terms a double deduction arises where a payment gives rise to a tax deduction in two countries but the income against which it is deducted is not included[7] in two countries.

2.2 Deduction without inclusion mismatch outcome (D/NI)

A deduction without inclusion mismatch outcome arises to the extent a payment, or part of a payment, is tax deductible in one territory without a corresponding amount being included in another territory. In simple terms, due to its hybrid nature, the payer makes a tax-deductible payment, but the payee does not see itself as receiving a corresponding amount.

2.3 Specific situations that give rise to a mismatch outcome

As mentioned, the anti-hybrid rules only apply in specific situations. These situations are set out in Part 35C:

Five types of hybridity are classified as giving rise to a 'mismatch outcome', being:

(a) a double deduction (Chapter 2 of Part 35C);
(b) a permanent establishment deduction without inclusion (Chapter 3 of Part 35C);
(c) a financial instrument deduction without inclusion (Chapter 4 of Part 35C);
(d) a payment to a hybrid entity deduction without inclusion (Chapter 5 of Part 35C); and

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[1] ATAD2 Recital 18, 19 & 20
[2] ATAD2 Recital 9 & 24
[3] This does not include a situation where a payment is made on or after 1 January 2020 in respect of an amount accrued and tax deductible in prior years.
[4] In recital 28 ATAD2
[5] In paragraph 13
[6] Article 2(9) 3rd(a)
[7] "Included" has a specific meaning under the anti-hybrid rules and is set out in further detail in section 3 of this manual

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(e) a payment by a hybrid entity deduction without inclusion (Chapter 5 of Part 35C).

Each of the above situations is dealt with separately in Part 35C (as outlined) with a specific scope of application section and specific rules to neutralise the mismatch outcome arising. For the rules to apply, the payments must be between entities that are associated enterprises (the term "associated enterprises" is specifically defined for the purposes of Part 35C).

Part 35C also covers the following as part of the anti-hybrid rules:

i. **Withholding tax** (Chapter 6 of Part 35C) where a hybrid transfer of a financial instrument is designed to produce relief for tax withheld at source to more than one of the parties involved,
ii. **Tax residency mismatch** (Chapter 7 of Part 35C) where a double deduction mismatch outcome arises as the taxpayer is dual resident,
iii. **Imported mismatch outcomes** (Chapter 8 of Part 35C) where a payment to a non-EU established payee directly or indirectly funds a mismatch outcome, and
iv. **Structured arrangements** (Chapter 9 of Part 35C) where the anti-hybrid rules are applied to any structured arrangement i.e. an arrangement designed to produce a mismatch outcome.

It is important to note that chapter 6, chapter 7 and chapter 9 apply the anti-hybrid rules to a payment irrespective of whether it is between entities that are associated enterprises.

In summary, for payments made on or after 1 January 2020 an Irish entity must consider whether a hybrid mismatch arises in the course of its cross-border transactions. When determining whether a hybrid mismatch does arise it is necessary to compare the tax treatment of a payment in a number of territories. Essentially where an Irish entity obtains a tax deduction in respect of a cross-border payment it must determine whether i) that payment has also given rise to a tax deduction in another territory against income that is not dual inclusion income or ii) whether a corresponding amount has been included in a payee territory.

To this end, the concept of "included" is important in analysing the anti-hybrid rules and is discussed further in Section 3 of this manual.

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3 Included

As already outlined, in determining whether a double deduction or deduction without inclusion mismatch outcome arises in the context of a cross border transaction the concept of included must be fully understood.

3.1 Corresponding amount

When testing for inclusion, the legislation sets out that a mismatch shall arise where it would be reasonable to consider that a "corresponding amount" has not been included in the payee territory. The term "corresponding amount" is important as it is not the "same amount" or an "equal amount". That is, if there is a deduction of €100 in the payer territory the test is not that an amount of €100 is included in the payee territory for a mismatch not to arise. Rather, the test is whether a "corresponding amount" has been included in the payee territory which allows account to be taken of variations that might arise due to differences in the value ascribed to payments between territories. These differences might arise through the application of transfer pricing or foreign exchange movements or might be due to temporary timing differences[8] between territories in terms of income and expenditure recognition. These differences should not fall within the scope of a hybrid mismatch[9].

The principles behind the concept of "corresponding amount" also apply when testing for dual inclusion income and when applying the anti-hybrid rules in the context of a worldwide system of taxation per section 835AB[10].

3.2 Test for inclusion

Firstly, it is noteworthy to state here that where there is more than one payee[11] to a transaction the test for inclusion need only be met once for a mismatch not to arise.

'Included' in respect of a payment has a specific meaning for the purposes of the anti-hybrid rules. The term is specifically defined in section 835Z(1) and essentially refers to an amount of profits or gains arising from the payment that is:

a) taken into account in the taxable income under the laws of the payee territory (the language "taken into account in the taxable income..." is per ATAD2 Art. 2(9) 2nd(e)), or
b) that is subject to a controlled foreign company charge or a foreign company charge (as defined in Part 35B of the Acts). (BEPS Action 2 para. 36 allows for the inclusion of a CFC regime).

When determining what is meant by (a) above, taken into account in the taxable income under the laws of the payee territory, a number of different scenarios are set

[8] In the context of a financial instrument deduction without inclusion mismatch it should be noted that there are additional requirements for inclusion and S835AH(2) sets out the conditions in this regard.
[9] Recital 22 ATAD2.
[10] Refer to Section 4 of this manual for relevant examples.
[11] The concept of payee will be discussed in a later section of this manual.

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out in section 835Z(1) depending on the tax status of the payee or the tax laws of the territory in which the payee is established.

3.2.1 Section 835Z(1)(a)

3.2.1.1 Chargeable to tax

Paragraph (a)(i) is relatively self-explanatory in that an amount of profits or gains is regarded as included where the payee is chargeable to tax (domestic or foreign) on that amount. The paragraph continues by clarifying that an amount will not be regarded as included where that amount is only chargeable to tax when it is remitted into the payee territory. Where the amount is considered to be remitted under a regime, e.g. under provisions similar in effect to section 72 TCA 1997 or is paid directly into the account of a payee in such a territory, and is chargeable to tax accordingly, it should be treated as included[12]. Once an amount is actually treated as remitted and chargeable to tax it will be regarded as included for the purposes of the rules, but any claim for a repayment of tax arising out of an amount becoming deductible must be made within the normal time limits[13].

3.2.1.2 Exempt profits or gains

Paragraph (a)(ii) refers to circumstance where the payee is exempt from tax, specifically where the payee is a pension fund, government body or other entity that is exempt from tax which generally applies to profits or gains. In such circumstance the profits or gains that are exempt from tax which generally applies to such profits or gains will be regarded as included for the purpose of the anti-hybrid rules such that no mismatch outcome will arise.

- Example of exemption:

  A Revenue approved charity will, where relevant conditions are met, typically have an exemption from income tax under sections 207 and 208 TCA 1997, corporation tax under sections 76 and 78 TCA 1997 and Capital Gains Tax under section 609 TCA 1997. The exemption from tax is subject to conditions but mainly the exemption applies in so far as the income and profits are applied to charitable purposes only. Where a foreign territory has a similar style of exemption in place, any profits or gains that qualify as exempt should be regarded as included for the purposes of the anti-hybrid rules. To the extent that the charity is in receipt of funds that are not applied to charitable purposes (e.g. if it carries on a trade) and are therefore taxable, these amounts are likely to be regarded as included under paragraph (a)(i).

In summary, where a payment gives rise to an amount that is not included as taxable income in the hands of the payee due to the payees exempt status that amount shall not give rise to a mismatch outcome under the anti-hybrid rules.

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[12] Refer to Tax and Duty Manual Part 08-03-06 for a further discussion on the remittance basis relating to interest payments where the interest is paid to an account located in the relevant territory.
[13] Refer to section 959V TCA 1997.

3.2.1.3 A territory, or part of a territory, that does not impose a foreign tax

Paragraph (a)(iii) deals with circumstances where the payee is established in a territory, or part of a territory, that does not impose a foreign tax. Where the general feature of a payee territory is not to impose a foreign tax, this should not give rise to a mismatch outcome. This also applies to situations where part of a territory does not impose a foreign tax such as "free zones" that have emerged in some territories to boost economic development.

"Foreign tax" is defined as a tax chargeable on profits and gains under the laws of another territory which is similar to domestic tax (domestic tax being defined as meaning income tax, corporation tax (including a controlled foreign company charge) or capital gains tax). Circumstances may arise where a territory imposes some foreign tax such that it does not fall within the definition of paragraph (a)(iii).

For example where a territory imposes a tax on income but not on capital gains. In these circumstances, payments to the territory potentially fall to be regarded as included under paragraph (a)(i) where they are income in nature and regarded as included under paragraph (a)(iii) if they are capital in nature. As previously outlined, the anti-hybrid rules only seek to counteract mismatches arising from hybridity and should not impact the general features of a tax system.

- Example:

  The corporation tax regime in Barbados imposes a tax on income but there are no specific rules on the taxation of capital gains. As such, payments to Barbados may fall within paragraph (a)(i) or paragraph (a)(iii).

  Irish company (I-Co) acquires a capital asset off a Bajan company (B-Co). I-Co claims a tax deduction in Ireland. Barbados does not have a capital gains tax, meaning that a potential Deduction / Non-Inclusion (D/NI) outcome arises. As both Ireland and Barbados see the acquisition as a capital transaction, if there was a D/NI outcome it would not be because of any hybridity but because of a general feature of the Barbados tax system. As such, the payment to B-Co should be regarded as included under paragraph (a)(iii) and no D/NI outcome arises.

3.2.1.4 Territorial tax regime

Paragraph (a)(iv) deals with circumstances where the payee is established in a territory that does not impose a tax on payments from sources outside that territory (i.e. where the payee is established in a country with a territorial tax regime). As this is a general feature of the tax system of a territory it should not give rise to a mismatch outcome under the anti-hybrid rules[14].

[14] Refer to Tax and Duty Manual Part 08-03-06 for a further discussion on the treatment of interest payments to a company in Hong Kong in specific circumstances.

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3.2.2 Controlled Foreign Company Charges [Section 835Z(1)(b)]

Section 835Z(1)(b) sets out that an amount that is subject to a controlled foreign company charge or a foreign company charge will be regarded as included for the purposes of the anti-hybrid rules. The terms "controlled foreign company charge" and "foreign company charge" are both defined in section 835Z(1) as having the same meaning as they have in the Controlled Foreign Company (CFC) legislation (Part 35B). A "controlled foreign company charge" is the Irish CFC charge per section 835R(2) which effectively charges to tax the undistributed income of a controlled foreign group (subject to relevant conditions). "'Foreign company charge' means a charge under the laws of a territory, other than the State, which is similar to the controlled foreign company charge".

When looking at charges that are similar to the CFC charge what is essential is whether a corresponding amount, in respect of a payment, has been included as taxable income under some regime that taxes foreign profits.

For example, for the purposes of the anti-hybrid rules income that is taxed under any of the regimes outlined below should be treated as included.

3.2.2.1 Controlled Foreign Company rules under ATAD

The Irish CFC rules contained in Part 35B transpose Article 7 of ATAD which essentially requires all Member States to implement rules that have the effect of re-attributing the income of a low-taxed controlled subsidiary to its parent company. Where an amount is subject to rules that have been introduced by other Member States under Article 7, or which were implemented prior to the Directive but are aligned with Article 7, it should be regarded as included for the purposes of the rules.

3.2.2.2 Global intangible low taxed income (GILTI)

Global intangible low taxed income or GILTI is a method of taxing US multinationals foreign profits. The regime specifically targets foreign intangible income arising from intellectual property. Essentially GILTI is a newly-defined category of foreign income that is added to the corporate taxable income of the US shareholder each year. Where a company can illustrate that a payment gives rise to an amount that is included in the GILTI calculation for the purposes of the groups US taxable income, that income should be regarded as included for the purposes of this section.

3.2.2.3 Transfer of assets abroad

National rules may have anti-avoidance provisions similar to section 806 and section 590 (and associated provisions) which charge a person to tax on income or gains arising to an offshore company. The US passive foreign investment company (PFIC) regime similarly aims to discourage US persons from forming a foreign corporation and using that company to invest in primarily passive investments, thereby attempting to shift income out of the US. Where an Irish payer can illustrate that a payment gives rise to a corresponding amount being included in the calculation of the amount charged to tax under such an anti-avoidance provision, the income should be regarded as included for the purposes of this section.

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4 Worldwide system of tax (section 835AB)

The Irish tax system is relatively simple and straight forward. For example;

- Ireland has a worldwide system of tax whereby companies are subject to tax on a current year basis on their worldwide profits and gains i.e. all profits arising in Ireland and all profits arising to foreign branches are subject to tax in the current year.
- Ireland does not have tax consolidation. Tax consolidation is where a country allows a group of companies to prepare a single tax return. In Ireland the requirement is to pay corporation tax on a company by company basis such that intragroup transactions are recognised in each individual company for tax purposes.

Section 835AB is designed to provide for the effective interaction between the anti-hybrid rules and Ireland's worldwide system of taxation. It combines specific rules (subsections (1) and (2)) with an overriding principle based anti-avoidance rule (subsection (3)) to ensure that Part 35C only neutralises actual economic hybrid mismatches and not juridical hybrid mismatches arising because of a worldwide system of taxation.

Paragraph (1) of section 835AB provides that the section applies where certain payments are disregarded ("disregarded payments") in an investor or payee territory when computing taxable profits in that territory under a provision similar to section 26(1) i.e. a worldwide system of taxation. The payments that may be "disregarded payments" for the purposes of this section are payments between;

(a) The head office of the entity and a permanent establishment of that entity,
(b) Two or more permanent establishments of the entity,
(c) Where the entity is a participator in a hybrid entity, the entity and the hybrid entity, or
(d) Where the entity is a participator in two or more hybrid entities, two or more such hybrid entities.

Paragraph (2) provides for situations where "disregarded payments" shall be treated as included in an investor or payee territory for the purposes of the anti-hybrid rules such that a mismatch outcome will not arise. This is best illustrated by way of examples.

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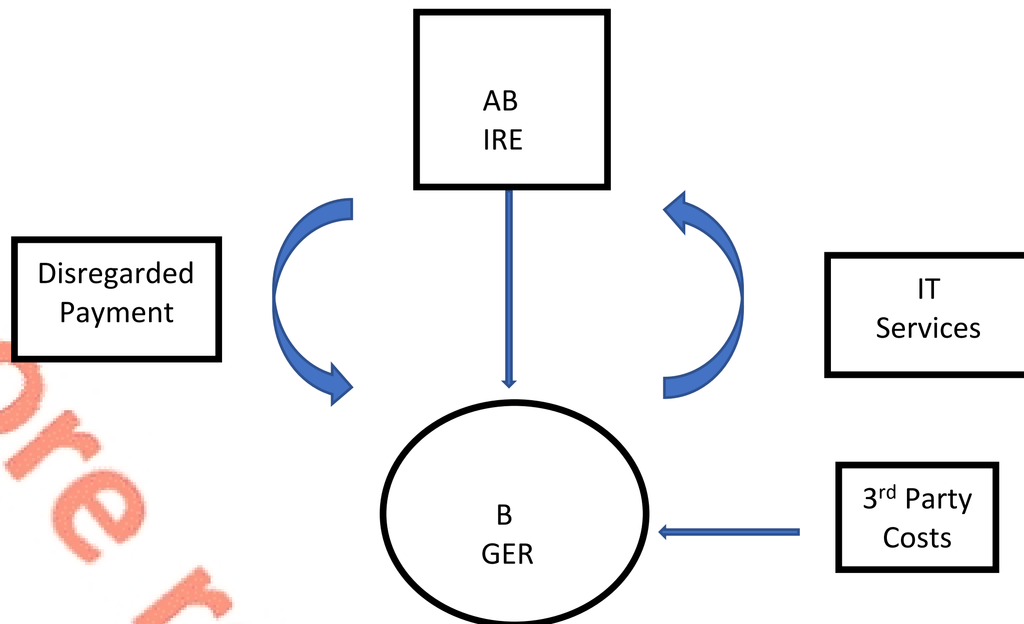
4.1 Worldwide system of taxation - Ireland

4.1.1 Example 1:



- Facts:

- AB IRE is an Irish company which develops and sells computer software.
- B GER is a German branch of AB IRE which provides IT services to AB IRE.
- B GER incurs 3rd party costs in respect of its IT services.
- AB IRE pays B GER an intra company payment in respect of the IT services. The intra company payment is a "disregarded payment" per paragraph (1)(a) of section 835AB. It is a payment between the head office of AB and a permanent establishment of AB that is disregarded when computing AB's taxable profits in Ireland.

- Interaction with the anti-hybrid rules:

- B GER takes a tax deduction in respect of its 3rd party costs against its income from AB IRE (intra-company income).
- AB IRE takes a tax deduction in respect of the 3rd party costs in GER, under its worldwide system of taxation, against its 3rd party income.
- There is a double deduction (in Germany and Ireland)
- Question: Is there dual inclusion income? Yes – but not as defined. Dual inclusion income is defined as any amount which is included in both territories where the mismatch outcome has arisen. In this example, the income in Germany is a payment that is disregarded in Ireland.
- However, under the worldwide system of taxation, B GER's income is in effect taxed twice. It is clearly taxed in Germany, but it is also included in the taxable income in Ireland as AB IRE does not regard (i.e. recognise for tax

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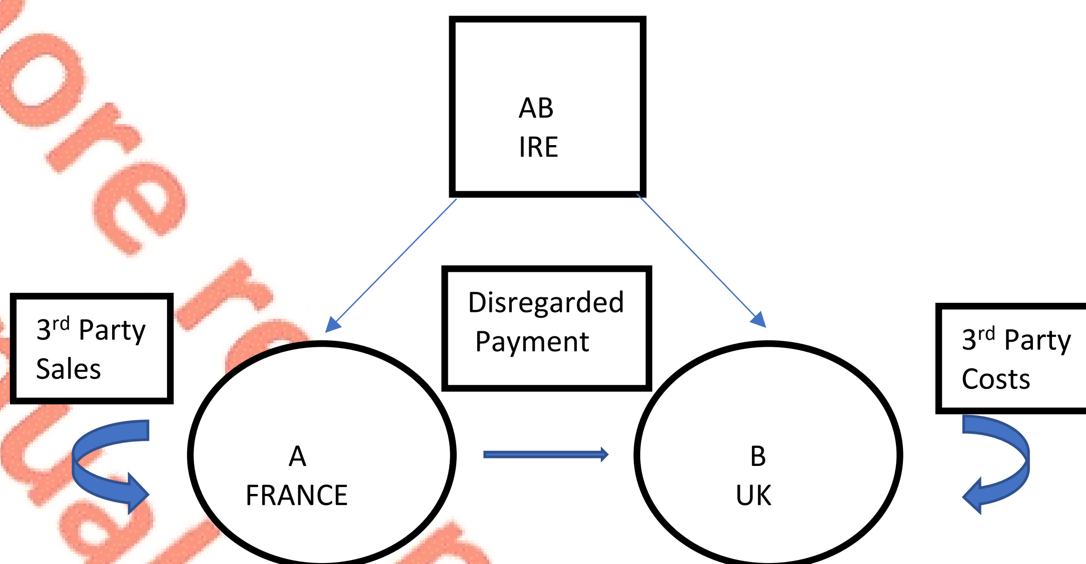
purposes) the intra-company payment and therefore it does not reduce AB's taxable income by the payment.

- Therefore, in effect B's income is taxed twice while B's costs are deducted twice. Under the worldwide system of taxation there is no net tax benefit.
- Section 835AB(2) operates by treating the disregarded payment between AB and B as included in AB for the purposes of the anti-hybrid rules such that the substance of the transaction is accurately reflected and a technical mismatch does not give rise to an adjustment where it should not.

4.1.2 Example 2:



- Facts:

- AB IRE is an Irish company
- B UK is a UK branch which incurs 3rd party costs manufacturing widgets that it sells to A France.
- A France is a French branch which buys widgets from B UK and makes 3rd party sales.
- Branch A pays Branch B an inter branch payment in respect of the widgets. The inter branch payment is a "disregarded payment" per paragraph (1)(b) of section 835AB. It is a payment between two permanent establishments of AB that is disregarded when computing AB's taxable profits in Ireland.

- Interaction with the anti-hybrid rules:

- B UK takes a tax deduction in respect of 3rd party costs in UK against its income from A France.
- A France is taxed on its 3rd party income, net of its expenses payable to B UK.
- AB IRE takes a tax deduction in respect of 3rd party costs in UK, under its worldwide system of taxation, against the 3rd party income of A France.

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- There is a double deduction (in the UK and Ireland) and dual inclusion income (in France and Ireland)
- Question: Is there dual inclusion income? Yes – but not as defined. Dual inclusion income is defined as any amount which is included in both territories where the mismatch outcome has arisen. In this example, the income in the UK is a payment that is disregarded in Ireland.
- There is therefore a juridical mismatch outcome but not an economic mismatch outcome as in the hands of AB, under the worldwide system of taxation, A's income is taxed twice while B's costs are deducted twice. In the hands of AB, A's expenses are not deducted, and B's income is not taxed. The interaction between A and B is effectively ignored such that there is no net tax benefit.
- Section 835AB(2) operates by treating the disregarded payment between A and B as included in AB for the purposes of the anti-hybrid rules such that the substance of the transaction is accurately reflected and a technical mismatch does not give rise to an adjustment where it should not.

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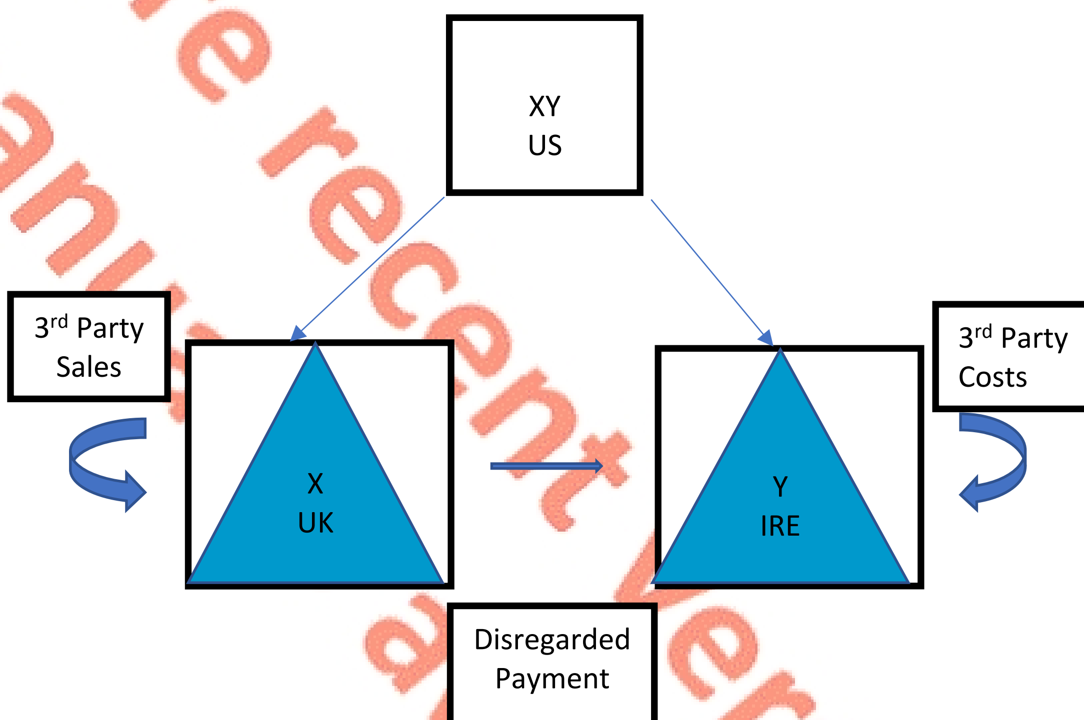
4.2 Worldwide system of taxation - the US

Hybridity is a feature of the US tax code arising from its check the box system of tax. Under this system foreign entities may be checked open (treated as transparent) or checked closed (treated as opaque) for the purposes of US tax. Essentially, the foreign entity becomes a hybrid entity.

Where foreign entities are checked open it is an effective worldwide system of tax whereby the US parent is taxed directly on the foreign profits and gains. In those circumstances, section 835AB operates by treating disregarded payments between a hybrid entity and its participator (paragraph (1)(c)) or between two or more hybrid entities of the same participator (paragraph (1)(d)) as included for the purposes of the anti-hybrid rules such that the substance of the transaction is accurately reflected and a technical mismatch does not arise where it should not.

4.2.1 Example 3: Interaction with US hybrid entities



- Facts:

- XY US is a US company
- Y IRE is an Irish company checked open (i.e. it is a disregarded entity) for US tax purposes. It incurs 3rd party costs manufacturing widgets to sell to X UK.
- X UK is a UK company checked open (i.e. it is a disregarded entity) for US tax purposes who buys widgets from Y IRE and makes 3rd party sales.
- X UK pays Y IRE an intragroup payment in respect of the widgets. The intragroup payment is a “disregarded payment” per paragraph (1)(d) of section 835AB. It is a payment between two hybrid entities of the same participator XY that is disregarded when computing the taxable profits in the US.

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- Interaction with the anti-hybrid rules:

- Y IRE takes a tax deduction in respect of 3rd party costs in IRE against its income from X UK.
- XY US takes a tax deduction in the US in respect of 3rd party costs in IRE against 3rd party income of UK under its check the box rules (X UK and Y IRE are treated as transparent for US tax purposes).
- There is double deduction (in the US and Ireland) and dual inclusion income (in the US and UK)
- Question: Is there dual inclusion income? Yes – but not as defined. Dual inclusion income is defined as any amount which is included in both territories where the mismatch outcome has arisen. In this example, the income in IRE is a payment that is disregarded in the US (as both X UK and Y IRE are checked open the US treats both companies as transparent effectively ignoring the intra-group transactions).
- There is therefore a juridical mismatch outcome but not an economic mismatch as, under the check-the-box rules, X's income is taxed twice while Y's costs are deducted twice. X's expenses are not deducted, and Y's income is not taxed. The interaction between X and Y is effectively ignored such that there is no net tax benefit.
- Section 835AB(2) operates by treating the disregarded payment between X and Y as included in XY for the purposes of the anti-hybrid rules such that the substance of the transaction is accurately reflected and a technical mismatch does not give rise to an adjustment where it should not.

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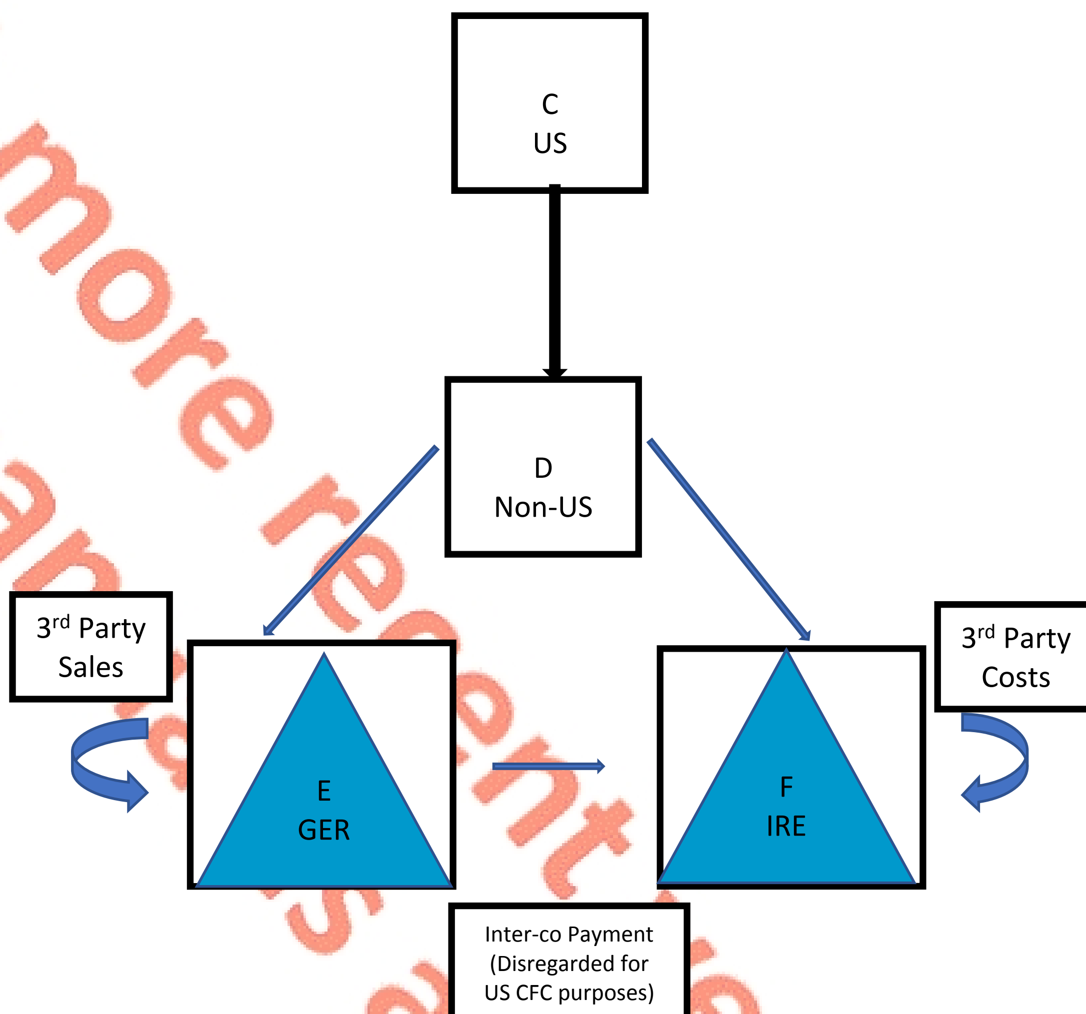
4.2.2 Example 4: Interaction with hybrid entities and the US CFC regime

As part of the US tax system, the profits and losses of foreign (i.e. non-US) entities can be considered as part of a CFC calculation (e.g. GILTI). This example illustrates the interaction of the anti-hybrid rules with hybrid entities that are CFCs whose profits form part of a CFC calculation.



- Facts:

- C US is a US company
- D Non-US is a non-US company that is not a hybrid entity.
- C US is subject to a CFC charge in the US. The CFC calculation is undertaken by reference to the profits and losses of its foreign subsidiaries, D, E and F.
- F IRE is an Irish company. It is a principal manufacturing company and incurs 3rd party costs as part of its manufacturing business. F IRE is taxed in Ireland on its profits.
- E GER is a German company, which operates as a sales and distribution company. It buys manufactured goods from F IRE and then sells these goods to third parties in Germany. E GER is taxed in Germany on its profits.
- C US regards E GER and F IRE as transparent entities.

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- Interaction with the anti-hybrid rules:

- In the US, C US calculates a CFC charge by reference to the aggregated profits and losses of D Non-US and its subsidiaries E and F (i.e. non-US), such that the economic profits of the non-US subsidiaries are included in the CFC calculation.
- When calculating its profits F IRE takes a tax deduction in Ireland in respect of 3rd party costs against its taxable income.
- These 3rd party costs are also factored into C US's calculation of taxable profits under the CFC regime.
- There is, therefore, a double deduction arising in respect of the 3rd party costs (in Ireland and the US).
- Question: Is there dual inclusion income arising in respect of the payment? Yes – but not as defined. Dual inclusion income is defined as any amount which is included in both territories where the mismatch outcome has arisen i.e. Ireland and the US. In this example, the intra-group income in F IRE is disregarded for US CFC purposes.
- However, included in respect of a payment means an amount of profits or gains arising from the payment:
    - (a)(i) that is chargeable to domestic tax.
        - ✓ An amount of profits arising from the 3rd party manufacturing costs (being the intra-group payment from E GER) is chargeable to tax in Ireland and therefore included in Ireland.
    - (b) that is subject to a controlled foreign company charge or a foreign company charge.
        - ✓ In the US, C US calculates its CFC charge by reference to the aggregated profits and losses of F IRE and E GER (and D Non-US). Essentially, the 3rd party sales in E GER are taxed while the 3rd party costs in F IRE are deducted in the CFC calculation. Therefore, although the intra-group payment from E GER to F IRE is disregarded for CFC purposes, an amount of profits arising from the 3rd party costs in F IRE (being the 3rd party sales in E GER) are taxed in the US and therefore included in the US.
    - Therefore, in effect, an amount of profits arising from the 3rd party costs is included in Ireland and the US i.e. dual inclusion income.

Essentially, there is no economic mismatch as F IRE's arm's length profits are subject to tax in Ireland, E GER's arm's length profits are subject to tax in Germany, and the combined profits of the non-US subsidiaries held by C (including D, E and F) are included in the US CFC calculation. There is no net tax benefit.

4.3 Section 835AB(3)

When applying section 835AB(1)(c) or (1)(d) to a particular transaction an Irish company must have regard to section 835AB(3) which sets out when these provisions will not apply. It is effectively a principle-based test which obliges the company to look to the substance of a transaction to ascertain whether a mismatch

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arises either in the context of ATAD or within the meaning of the term mismatch when construed in accordance with the BEPS Action 2 report. ATAD sets out[15] that:

> "…*hybrid mismatches are the consequence of differences in the legal characterisation of payments (financial instruments) or entities and those differences surface in the interaction between legal systems of two jurisdictions…. In this context, it is useful to clarify that measures aimed to tackle hybrid mismatches in this Directive are aimed to tackle mismatch situations attributable to differences in the legal characterisation of a financial instrument or entity*".

The executive summary of the BEPS Action 2 report provides that:

> "**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.**"

Therefore before availing of the treatment allowed in section 835AB(2), the company must be able to illustrate that the transaction has not resulted in double non-taxation (including long-term deferral).

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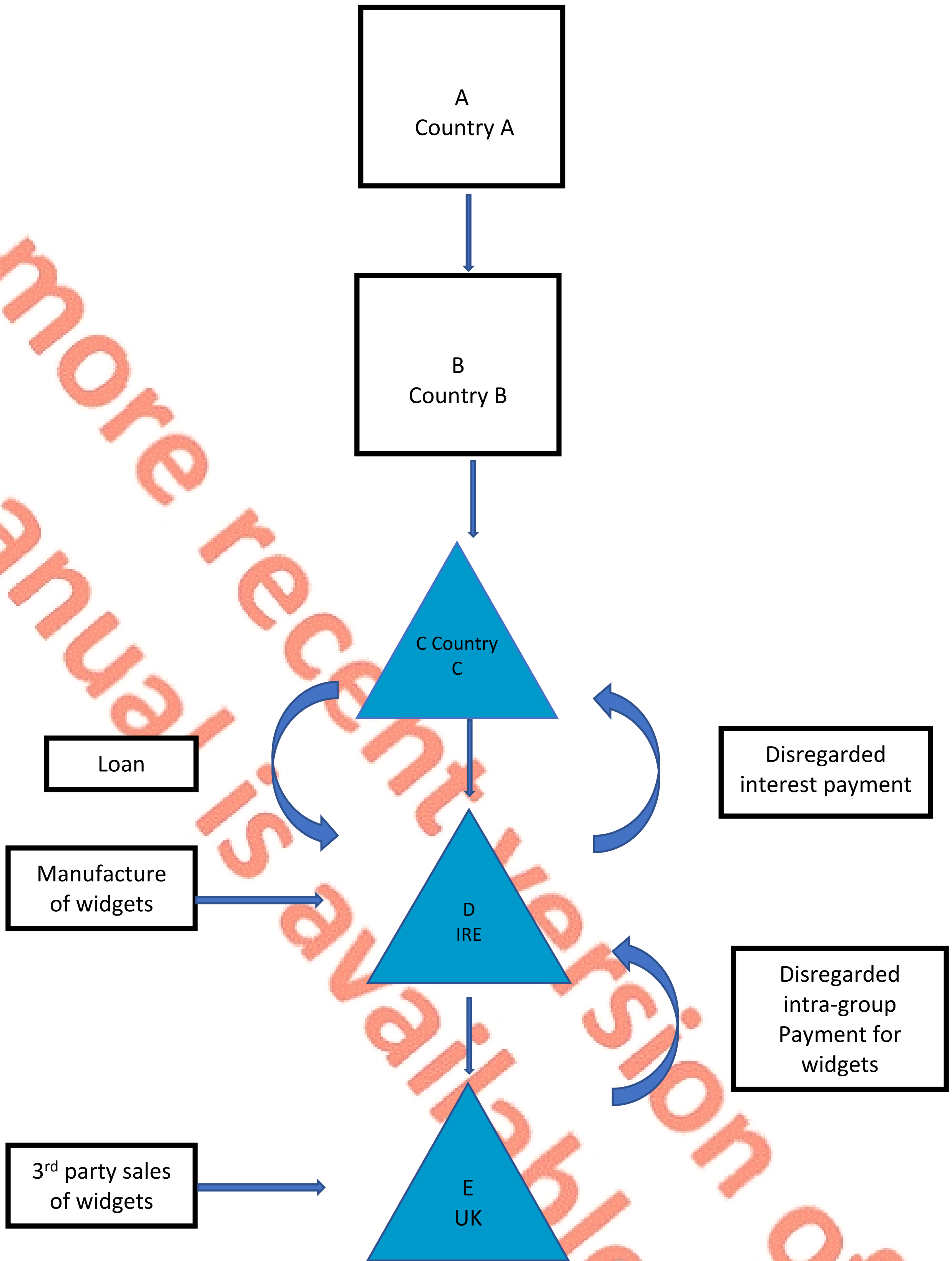
[15] In recital 13

4.3.1 Example 5:



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- Facts:

- A is the parent company of an international corporate group manufacturing widgets.
- B is an intermediate holding company. It is regarded as a corporation from both Country B and Country A's tax perspective. It is not a hybrid entity.
- C is a transparent entity from Country C's tax perspective. B is its participator but it regards C as a company which is tax opaque in Country B. B is not chargeable to tax on C's income. C is a hybrid entity.
- D IRE is an Irish manufacturing company. It manufactures widgets. In order to fund its manufacturing activities, D IRE has received an intra group loan from C. D IRE makes interest payments to C in respect of this loan. D IRE is chargeable to Irish corporation tax. D IRE is a disregarded entity from Country A's tax perspective. It is a hybrid entity.
- E UK is a UK sales and distribution company. It buys the widgets from Ireland and sells in the EMEA market. It makes an intra group payment to D IRE in respect of the purchase of the widgets. It is chargeable to UK corporation tax in the UK. It is a disregarded entity from Country A's tax perspective. It is a hybrid entity.

- Interaction with the anti-hybrid rules:

- D IRE (hybrid entity) makes an interest payment to C (hybrid entity).
- D IRE takes a deduction in respect of the interest payment against its taxable income (the intra group payment from E UK in respect of the widgets).
- Question: is there a payment to hybrid entity deduction without inclusion mismatch (per S835AL)? There is a deduction in D IRE in respect of the interest payment but is there inclusion in the payee territory?
    - C is a payee as it receives the payment. C is a transparent entity from Country C's perspective. The payment is not taxed in C.
    - B is a payee as it is the participator of C. B regards C as opaque and does not tax the payment.
    - Therefore, there is no inclusion in the payee territory of either C or B.
- A is not a payee (as defined in S835Z(1)) in respect of the interest payment in this example:
    - It does not receive the interest payment
    - It is not a participator of C
    - The interest payment is not treated as arising to its benefit
    - A CFC charge is not made on A by reference to the interest payment as the interest payment is disregarded for CFC purposes.
- In this example, section 835AB(3) provides that sections 835AB(1) and (2) cannot be relied upon as there is, in substance, a mismatch outcome.

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Essentially, where an Irish company obtains a tax deduction in respect of a payment, or part of a payment, it must be able to illustrate that a mismatch does not arise either because:

i) a corresponding amount has been included in the payee territory, or
ii) there is dual-inclusion income i.e. income that is included twice.

In this regard the definitions of “payee” and “included” are important and how they interact with section 835AB(3).

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5 Similar provisions

Section 835Z(2) sets out that where there is a reference in the anti-hybrid rules to a provision of the law of a territory, other than the State, which is similar to Part 35C that reference is to a provision that is enacted to;

(a) give effect to ATAD or is aligned with ATAD in the case of measures already in place,
(b) implement the OECD BEPS Report on Neutralising the effects of hybrid mismatch arrangements,
(c) implement the OECD BEPS Report on Neutralising the tax effects of branch mismatch arrangements, or
(d) otherwise neutralise a mismatch outcome.

In terms of determining what is meant by (d) the following is a non-exhaustive list of provisions that are similar in effect to the anti-hybrid rules.

5.1 Provision similar to section 817C

Where a territory applies a provision similar to section 817C in terms of restricting interest deductibility when paid to connected parties who are not yet chargeable to tax, it shall be regarded as having similar effect to the anti-hybrid rules.

5.2 EU Parent-Sub Directive

The EU Parent-Sub Directive contains provisions aimed at counteracting mismatches between a parent and subsidiary territory specifically double non-taxation on foot of hybrid loan arrangements. As the provisions operate to neutralise a mismatch scenario they are regarded as having similar effect to the anti-hybrid rules.

5.3 Switch-over clause

To avoid double non-taxation, recently concluded German tax treaties often include a switch-over clause allowing Germany, as the state of residence, to switch over from a tax exemption method to a tax credit method with respect of foreign income to avoid non-taxation. As these, and other, switch-over rules operate to prevent a deduction non-inclusion outcome they are regarded as having similar effect to the anti-hybrid rules.

5.4 US dual consolidated loss rules

The dual consolidated loss (DCL) rules were enacted to address situations where a US domestic corporation, that was treated as dual resident, could effectively double dip a single economic loss, once to offset income subject to US tax and a second time to offset income that is subject to foreign tax. As the DCL rules target the issue of double deductions they are regarded as having similar effect to the anti-hybrid rules.

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