Since the financial crisis in 2008, the tax, regulatory and political landscape within the European Union has evolved—and is expected to change further still in the years to come. The daily life of an asset manager now involves regular re-education on new acronyms and ongoing changes within the industry. Such a dynamic environment has sparked a shift in requirements and a need to adapt at all levels of the operating model and value chain.

In particular, following the implementation of the OECD’s Base Erosion and Profit Shifting (BEPS) measures, the European Commission presented an anti-tax avoidance package on 28 January 2016 and, by 20 June 2016, the Anti-Tax Avoidance Directive (ATAD I) was adopted. The aim of ATAD I was to create a minimum level of protection against corporate tax avoidance throughout the EU, while ensuring a fairer and more stable environment for businesses. The ATAD I introduced five measures including hybrid mismatch provisions between European jurisdictions.

On 29 May 2017, the EU Council approved Directive 2017/952/EU (ATAD II or the “Directive”), which amended ATAD I. The ATAD II aims to extend the scope of ATAD I for hybrid mismatches involving non-EU countries.

As with any EU directive, the measures of ATAD II first need to be implemented into each EU Member State’s domestic tax legislation. Expectation is that EU Member States are able to introduce domestic legislation for ATAD II to be applicable as of 1 January 2020 (except for reverse hybrid mismatches, which may be applicable with a delay, as of 1 January 2022). The full impact of ATAD II has to be addressed upon transposition in domestic tax law by each EU Member State—only a few have initiated this transposition process at time of going to press.

However, it is expected that ATAD II will have a significant impact on how real estate alternative investment funds, and its investments, will be structured. Hence, the aim of this article is to shine a spotlight on the potential consequences of ATAD II for real estate asset managers and to outline some ideas as food for further thought.
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Focus on hybrid mismatches
The objective of the hybrid mismatches provision is to neutralize the tax effects of hybrid arrangements, which exploit differences in the tax treatment of an entity or instrument under the laws of two or more EU Member States (MS) as well as in relation to non-EU or third countries.

A hybrid mismatch could be defined as the difference in the legal characterization of a financial instrument or an entity when either:

• A structured arrangement exists between the taxpayer and a party established in another jurisdiction

• A commercial or financial relationship exists between the taxpayer and an “associated enterprise” (as explained further below) established in another jurisdiction (including a permanent establishment of an entity in another country); and

To the extent, this could result in:

• Deduction of a payment without a corresponding inclusion of such payment in the taxable income of the payee (also referred to as “deduction without inclusion”). Broadly, there is a deduction without inclusion when a payment is taken at the level of the paying entity without a corresponding inclusion for tax purposes of the same payment at the level of the receiving entity

• Deduction of the same operational expenses or losses (also referred to as “double deduction”). This refers to occasions when a deduction of the same payment, expenses or losses, occurs in an entity in which the payment has its source, the expenses are incurred, or the losses are suffered and in another entity.

In fact, the definition tackles two categories of hybrids: hybrid instruments and hybrid entities, resulting in either, deduction without inclusion or double deduction of a payment. We focus below on some of the focal concepts of these hybrid provisions.

Hybrid instrument and hybrid entity
The hybrid instrument
Article 9 of the Directive describes the case of a hybrid instrument, which could be largely interpreted as the hybrid mismatches that result from payments under a financial instrument.

Typically, a financial instrument may be affected by rules where the tax treatment (resulting from its qualification [debt or equity]) will differ from the payer jurisdiction. The Directive describes the cases of:

• Hybrid mismatches that are the consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment (including, payments to a disregarded permanent establishment)

• Hybrid mismatches that result from payments made by a hybrid entity to its owner, deemed payments between the head office and permanent establishment, or between two or more permanent establishments that are disregarded in the payee jurisdiction.

If the hybrid mismatch results in a deduction without inclusion, and regardless of whether the mismatch results from an entity or an instrument, the deduction will be denied in the jurisdiction of the payer (primary rule). Alternatively, the payment could be included in the tax base of the payee jurisdiction in case the deduction is not denied in the payer jurisdiction (secondary rule).

If the hybrid mismatch results in a double deduction, the deduction will either be denied in the investors’ jurisdiction or in the payer jurisdiction’s Member State (in case the deduction is not denied in the investor jurisdiction). Nevertheless, any double deduction will be eligible to set off against double inclusion of income.
EU Member States will each need to ascertain these provisions and determine their implementation rules with regards these ball-park concepts, and in particular how to navigate between these (primary vs. secondary) rules across multiple jurisdictions.

**The principle of “associated enterprise” and the tricky concept of “acting together”**

Hybrid mismatch outcomes may arise if either it involves two associated enterprises or, a taxpayer and an associated enterprise. An associated enterprise means an entity or an individual, which holds, directly or indirectly, a participation of more than 25% (50% in the case of hybrid entities) in the voting rights, capital ownership or profits of another entity.

Additionally, the Directive also extends the concept of associated enterprise to “a person who acts together with another person in respect of the voting rights or capital ownership of an entity and 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”. This is the so-called “acting together” concept.

Hence, the “associated enterprise” principle also covers a person who “acts together” with another person in respect of the voting rights or capital ownership of an entity. That person will be treated as holding a participation in all of the voting rights or capital ownership of that entity holding by the other person.

The “acting together” concept is newly introduced by ATAD II and, as yet, has not been clearly defined (some countries though, have similar concepts, that could provide basis for interpretation). However, ATAD II invites EU Member States to use the applicable explanations and examples provided by the Action 2 Report as a source of illustration or interpretation as they are consistent with the provisions of ATAD II and EU Law.

According to the Action 2 Report, two persons will be treated as “acting together” in respect of ownership or control of any voting rights or equity interest if:

- They are members of the same family
- One person regularly acts in accordance with the wishes of the other person
- They have entered into an arrangement that has material impact on the value or control of any such rights or interest
- The same person or group of persons manages the ownership or control of any such rights or interest.

As noted above, the “acting together” concept is already present in some jurisdictions and used in different contexts, and may provide some guidance. However, given the pending implementation of the Directive, the interpretation of this concept should be closely monitored.

**The reverse hybrid concept**

Another introduction by the ATAD II, is the reverse hybrid mismatch concept. The related rules are applicable as of 1 January 2022. The reverse hybrid concept is applicable when one or more associated non-resident entities are holding (directly or indirectly) an aggregate of more than 50% of the voting rights, capital interests or rights to share profit in a hybrid entity incorporated in a MS. Non-resident entities view the hybrid entity as a taxable person (tax opaque) while the entity is tax transparent based on the laws of its Member State.

However, the hybrid entity in such circumstances should be regarded as a taxable person (tax opaque) in that Member State and taxed accordingly. The reverse hybrid rules do not apply for a collective investment vehicle as such an investment fund or vehicle holds a diversified portfolio of securities and is subject to investor-protection regulation in the Member State.

**What do these mean for fund managers?**

The following should be on the watch list for real estate asset managers:

**Regarding hybrid instruments and hybrid entities**

As per the Action 2 Report, the different tax qualification of a debt instrument between the lender and borrower states may lead to a hybrid mismatch outcome and result in denial of the related deduction in payer
jurisdiction (primary rule). The same mismatch situation may arise in the case of such a debt instrument attributed to an investor in a tax transparent investment (fund) vehicle, should the investor qualify the instrument differently from the payer jurisdiction.

A hybrid mismatch may also occur when the qualification of an entity considered as tax transparent in one jurisdiction, but considered as opaque from the other jurisdiction's perspective, leads to a discrepancy in the tax treatment of any payment made.

If left unchecked, these may create unintended deductibility concerns within a fund holding structure (in particular regarding the internal [shareholder] financing), or create an additional layer of taxation at fund/investor level. In light of this, fund managers will need to consider, identify and monitor their investor base. This is not a one-time only exercise, but goes hand-in-hand with continuous monitoring activity (beyond tax).

It should not be a well-intended exercise to identify the implications of correct feeder/blocker vehicles within a structure, but instead should be considered as part of the ongoing operational aspects of an investment fund.

The “acting together” concept
As mentioned before, hybrid mismatch may arise between associated enterprises meeting a 25-50% participation threshold.

Therefore, one might think that the hybrid mismatch rules may be of less concern to widely-held, collective investment vehicles. However, given the “acting together” concept, there could be an impact on the alternative investment fund industry at fund level. Since this concept may group investors whose investments are managed under a common mandate (e.g. same class of investors) or who are partners in an investment partnership, it may bring them back within the scope of the hybrid mismatch rules.

Hence, until there is further clarification via the domestic implementation of the Directive, it remains uncertain as to how to interpret the “acting together” concept within the alternative fund industry and the implications thereof.

Reverse hybrid and imported mismatches
Although there is a carve-out reference to collective investment vehicles within the Directive, it remains unclear as to whether this refers to regulatory supervision only, or if semi- or unregulated products are covered as well (provided they are managed by an authorized investment manager who is then subject to supervision).

It may well only refer to UCITS and completely exclude so-called non-CIV products—like most alternative investment funds.

Investor relations
Identifying sources of possible hybrid mismatch cases is one issue arising from the various hot topics circulating around the implications of ATAD II. However, how to manage investor relations in this respect is even more difficult.

Fund managers and advisors should actively work together to assess the possible ATAD II implications to investors, and address the related safeguards included in the relevant fund documentation (e.g. a clawback clause in the fund documentation or a questionnaire in the subscription booklet).

Take away
The ATAD II items are raising challenges both at fund level and from an investment structuring perspective. Asset managers now need to carefully consider the type of fund products and structure, in line with their investor base, to remain attractive whilst adapting their operational model to comply with the recent regulations arising from BEPS.

The impact of the hybrid mismatches need to be assessed on a case-by-case basis. Timing will be of the essence as the parameters of the Directive will be applicable as of 1 January 2020 (with an exception for 2022 for reverse hybrid mismatches). Hence, the implications of ATAD II will be immediate and will affect the practice as from fiscal year 2020 onwards.