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A look at the new anti-hybrid mismatch arrangements rules in Portugal

Ricardo Seabra Moura and Rita Pereira de Abreu of Vieira de Almeida analyse the challenges that lay ahead following the implementation of the rules.

Following the transposition into domestic law of EU Anti-Tax Avoidance Directive (ATAD) I, as amended by Directive (EU) 2017/952 of May 29 2017 (ATAD II), Law 24/2020 of July 6 2020 has implemented the missing anti-hybrid mismatch arrangement rules into Portuguese law.

Although the rules for reverse hybrid mismatch arrangements will only be effective from January 1 2022, the legislation entered into force as of January 1 2020. Portugal has opted to exclude certain intra-group financial instruments, issued with the purpose of meeting the issuer's loss-absorbing capacity requirements from the scope of the new legislation, until December 31 2022.

As a preliminary note, the entry into force of these amendments halfway through a taxable period, and with effects as of the beginning of the year, raises some temporal application challenges that should be safeguarded.

The implementation of anti-hybrid mismatch arrangement rules has mainly involved a mere 'copy and paste' of the wording of ATAD II to a new chapter of the corporate income tax (CIT) code. The fact that hybrid mismatch arrangement rules were completely innovative *vis-à-vis* the Portuguese legal framework may have led the legislator to simply replicate in domestic law the rules foreseen in ATAD II.

If, on the one hand, this *modus operandi* brings harmonisation among all EU member states, on the other hand, we take the view that the implementation of these rules required a more comprehensive amendment to domestic law (and will certainly require clear administrative guidance) to ensure certainty and clarity on the functioning of the new mechanisms, alongside other existing rules.

The entry into force of these rules raises questions of harmonisation with other domestic provisions, such as transfer pricing rules, the parent-subsidiary directive (will this immediately qualify as a non-genuine arrangement?), controlled foreign companies and interest barrier rules, which were already foreseen in the Portuguese legal framework and have been amended as per ATAD I.

In this regard, Law 24/2020 has only amended the interest limitation rule, by removing securitisation companies from the category of entities that are not subject to interest barrier rules. This exemption continues to apply to supervised banking entities, insurance entities, pension funds, branches located in Portugal of credit institutions, other financial institutions and insurance companies.

The new domestic rules specifically cover financial instruments, hybrid entities, reverse hybrid entities, permanent establishments, tax residency and imported mismatch arrangements but they do not contain a *de minimis* threshold or a grandfathering exclusion, which may require a careful analysis by compliance and tax departments to understand if a transaction falls within the scope of hybrid mismatch arrangements.

To determine whether a situation falls within the scope of the new anti-hybrid mismatch arrangements rules, one should consider the outcome rather than the starting point (i.e. the possible conflicting qualification) of a payment, an entity or a financial instrument.

In simple terms, the new rules aim at tackling hybrid mismatch arrangements that give rise to:

- A deduction/no-inclusion mismatch (e.g. redeemable preference shares, profit participation rights, convertible secured or unsecured bonds that are treated as debt in Portugal and equity in foreign jurisdictions); and
- A double deduction mismatch (where a deduction is available in two or more countries for the same payment).

As foreseen in ATAD II, the rules link the tax treatment in Portugal to the treatment granted in the other country involved. In double deduction situations, the primary rule requires that the investor's jurisdiction refuse to deduct the cost; whenever it does not, the secondary rule provides that such deduction shall be denied by the country where the payment is sourced (as a defensive rule).

Where the hybrid mismatch arrangement results in a deduction/no-inclusion outcome, the primary rule requires that the deduction be denied by the payer jurisdiction; whenever it is not, the secondary rule provides that the payer jurisdiction shall include the income in the taxable income of the recipient.

Certain questions still require further testing, clarification and regulation, notably:

- Who will be responsible for evidencing the non-deductibility of payments made by a company if a tax exemption is claimed for such payments?; and
- How should adjustments under the anti-hybrid mismatch arrangements rules be operated in cases where the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period?

As the transposition took place a few months ago, it is yet unclear how the rules (technically difficult to interpret) will be applied in practical terms by the Portuguese tax authorities on transactions made with Portuguese based entities.

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