

# The penalty protection for hybrid mismatches

Background

Hybrid mismatches

Penalty protection

Conclusions

## Background

The Tax Reform Act of August 9, 2023, No. 111, delegated the government, among other things, to carry out a general review of international aspects of the Italian tax system.

Under the aforementioned tax reform, Legislative Decree No. 209 of December 27, 2023, was enacted, Title III of which contains the *Provisions to Promote Compliance on Hybrid Mismatches*.

To the extent of interest here, Article 61 (*Provisions on documentation regarding hybrid mismatches*), in order to **promote cooperation** between the tax authorities and taxpayers and to ensure proportionality in the application of hybrid mismatches provisions, introduced a new paragraph 6-bis to Article 1, Legislative Decree No. 471 of December 18, 1997, which now provides that

*“in the event of a dispute relating to the provisions on mismatches from hybrids referred to in Chapter IV of Legislative Decree No. 142 from which a higher tax or credit reduction results, the penalty referred to in Paragraph 2 shall not apply if, during the access, inspection or verification or other preliminary activity, the taxpayer delivers to the Tax Administration the documentation, having a certified date, indicated in a specific decree of the Minister of Economy and Finance suitable to allow the verification of the application of the rules aimed at neutralizing mismatches from hybrids. The taxpayer who holds the documentation provided for in the decree referred to in the first sentence shall give appropriate notice to the tax authorities in accordance with the procedures and terms specified therein. In the absence of said communication, paragraph 2 shall apply”.*

The functioning of this provision was ensured through the issuance by the Ministry of Economy and Finance of the Decree of December 6, 2024, published in the Official Gazette No. 298 of December 2024.

## Hybrid mismatches

As part of an international context aimed at neutralizing international schemes aimed at obtaining tax savings through aggressive forms of tax planning that cannot be confronted by implementing the principle of the prohibition of abuse of rights, and in implementation of Directive (EU) 2016/1164 ATAD 1, as amended by Directive (EU) 2017/952 ATAD 2, the Italian legislator published Legislative Decree No. 142 of November 29, 2018 (“Decree”).

The Decree’s **anti-hybrid measures** are aimed, in particular, at **countering the effects of double deduction<sup>1</sup> or deduction without inclusion<sup>2</sup>** arising from conflicts in the qualification of financial instruments, payments, entities, permanent establishments or the

<sup>1</sup> According to Article 6 of the Decree, double deduction means “a deduction of the same negative income component in the jurisdiction in which it is incurred or deemed to be incurred, i.e., the payer’s jurisdiction, and in another jurisdiction, i.e., the investor’s jurisdiction. In the case of a negative income component incurred by a hybrid entity or permanent establishment, the payer’s jurisdiction is the jurisdiction in which the hybrid entity or permanent establishment is established or located”.

<sup>2</sup> Under Article 6 of the Decree, deduction without inclusion means “the deduction of a negative component of income in any jurisdiction in which the same is incurred or deemed to be incurred, i.e., the payer’s jurisdiction, without the corresponding inclusion for tax purposes of the related positive component of income in the beneficiary’s different jurisdiction. The payee’s jurisdiction is any jurisdiction in which the positive income component is earned or deemed to be earned under the laws of any other jurisdiction”.

allocation of payments, as well as obtaining an undue credit for foreign taxes originating from the exploitation of a mismatch concerning a financial instrument.

As also clarified within Internal Revenue Service Circular No. 2 of January 26, 2022, the **prerequisites** for the activation of the reaction rules are:

- the presence of a **mismatch**, that is, an effect of double deduction or deduction without inclusion;
- the presence of a **hybrid cause**;
- the **subjective element**, i.e., whether the misalignment occurs between associated enterprises<sup>3</sup>, between a taxable person and an associated enterprise, between the parent company and the permanent establishment, between two or more PEs, or even within a “structured agreement”<sup>4</sup> to which the taxable person is a party.

The **reaction rules**, contained within Article 8 of the Decree consist of (i) in the case of actual existence of a double deduction effect in the context of an agreement between associated parties or in the context of a structured agreement, the disallowance of the deduction in the hands of the taxpayer who qualifies as an investor or, if the taxpayer is the payer, the disallowance of the deduction in the hands of such taxpayer or (ii) in the case of the actual existence of a deduction effect without inclusion under an agreement between associated parties or in the context of a structured agreement, in the disallowance of the deduction in the hands of the taxable payer or, where the taxable payer is the beneficiary, in the inclusion of the corresponding passive income component in the taxable payer’s tax base.

## *Penalty protection*

As anticipated, the Ministerial Decree of December 6, 2024 (“Ministerial Decree”), in implementation of Article 1(6-*bis*), Legislative Decree 471/1997, has regulated the so-called **penalty protection** in case of disputes on hybrid mismatches by providing, under certain conditions, the **inapplicability of penalties for false tax return**.

More precisely, the penalties do not apply where, during the access, inspection or audit or other investigative activity, the taxpayer delivers to the tax authorities the **documentation**, indicated in the Ministerial Decree, **having a certified date and suitable to allow the tax authority to verify the application of the rules aimed at neutralizing hybrid mismatches**.

Proceeding to an analysis of the Ministerial Decree, under Article 2 the aforementioned documentation can be submitted by any taxable person, resident or located in Italy, or by

<sup>3</sup> “(1) an entity in which the taxpayer directly or indirectly holds an interest in terms of voting rights or ownership of capital equal to or greater than 50 percent or has the right to receive a percentage of the profits of such entity equal to or greater than 50 percent; (2) an individual or entity that directly or indirectly holds an interest in terms of voting rights or ownership of capital equal to or greater than 50 percent or has the right to receive a percentage of the profits of the taxpayer equal to or greater than 50 percent (3) an entity that is part of the same consolidated group for financial accounting purposes as the taxpayer; (4) an enterprise in which the taxpayer exercises a dominant influence over the management within the meaning of Article 2359 of the Civil Code; (5) an enterprise that exercises a dominant influence over the management of the taxpayer within the meaning of Article 2359 of the Civil Code” Article 6 of the Decree.

<sup>4</sup> Meaning: “an arrangement that results in a hybrid mismatch where the economic impact of the mismatch has been assessed in the negotiation of the terms of the arrangement or an arrangement designed to produce a hybrid mismatch, unless the taxpayer or an associated enterprise could reasonably be unaware of the mismatch and has not shared the value of the tax benefit resulting from the hybrid mismatch,” Article 6 of the Decree.

a so-called designated taxable person<sup>5</sup>, thus reducing, in the case of multinational groups, the administrative burden resulting from the preparation of the documentation.

Within Article 3, the prerequisites for taxpayers to be able to ensure the production of the penalty protection are enshrined, stipulating that the **documentation**, in order to be considered **eligible**, must contain the provisions of Annex A (which identifies the information necessary for the analysis of the internal process), while Annex B outlines the procedure that the taxpayer must follow in order to recognize relevant transactions and homogeneous groups.

Pursuant to Articles 4, 5 and 6, the documentation (i) is annual; (ii) must be drafted in the Italian language and in electronic format; (iii) must be signed by the taxpayer's legal representative or his delegate, by means of an electronic signature with a time stamp, to be affixed no later than the date of submission of the tax return for the tax period (an additional 90 days is granted, however, in case the taxpayer submits the return late); and (iv) must be submitted for each tax period, giving evidence of the transactions likely to generate mismatches.

In addition, the documentation must be prepared separately for each specific entity: as clarified within the Technical Report to the Ministerial Decree, *“even in the specific case of a multinational group, it is true that the documentation must contain information related to the group as a whole, but it should be separated with reference to the individual taxpayers”*. The penalty protection is subject to the submission of the requested documentation within the unailing period of 20 days. Where it is necessary to acquire additional information for the purposes of the audit, an additional 30 working days shall be granted to the taxable person.

As indicated by Article 8, the documentation is effective for the tax period to which it relates and must be retained until the assessment deadline. Moreover, the penalty protection is not lost in the presence of incomplete, untrue or noncompliant contents, where such omissions or inaccuracies are not likely to compromise the analysis of the tax authorities.

Again, under Article 9, reporting to the Internal Revenue Service by the taxpayer who prepared the documentation must be done by specific indication contained in the annual tax return for the relevant tax year.

The effectiveness of the documentation is subject to compliance with the requirements set forth in Articles 4, 5, 6, 8 and 9 (Art. 7).

It is also specified that failure to indicate in the documentation a relevant transaction or the unsuitability of its representation within the documentation does not result in the ineffectiveness of the documentation with respect to other relevant transactions.

This determines, with reference to relevant transactions from which **mismatches from so-called direct hybrids** may arise, the possibility for the taxpayer to choose for which transactions to access the penalty protection.

With reference, on the other hand, to **imported mismatches**<sup>6</sup>, the documentation should

<sup>5</sup> *“The taxable person resident or located in the territory of the Italian state designated by the other taxable persons resident or located there to submit the documentation on their behalf”* Article 1 of the Ministerial Decree.

<sup>6</sup> As clarified within Circular 2/2022, *“this definition does not qualify an independent category of hybrid mismatch, but rather refers to a case in which the effects of a hybrid mismatch originated between two jurisdictions and not neutralized (first-tier hybrid) reverberate in another jurisdiction (second-tier hybrid)”*. Thus, *“the case of imported hybrid concerns ‘composite’ transactions through which an effect of deduction without inclusion or double deduction, generated between foreign jurisdictions where the anti-hybrid mismatch rules have either not been introduced or have been introduced in a manner that differs from the minimum standard of protection provided by the ATAD Decree, is transferred (imported) to jurisdictions that*

be considered suitable for allowing the verification of the application of the rules aimed at neutralizing mismatches where it is demonstrated that there is an internal evaluation process in which the analysis path adopted is made explicit and that it complies with the adequacy requirements indicated within the same Ministerial Decree.

As stated within the Technical Report to the Ministerial Decree, for mismatches from imported hybrids, penalty protection is ensured, in each case, on individual relevant transactions<sup>7</sup> and homogeneous groups<sup>8</sup> for which appropriate and adequate documentation has been prepared, and this is regardless of the adequacy and completeness of the internal process of analysis and control, as a whole assessed.

As specified within Article 10, the absence or unsuitability of such documentation cannot be considered, *per se*, as evidence of a hybrid mismatch.

Finally, with regard to the relationship between the penalty protection under consideration and the **collaborative compliance regime**, Article 12 provides that the correct and timely submission of documentation, together with the timely disclosure of its possession to the Internal Revenue Service, constitutes for the taxpayer the correct and timely fulfillment of disclosure and transparency obligations.

In addition, and with reference to **transactions with a value below the materiality threshold**<sup>9</sup>, the provision provides that it is sufficient for the taxpayer, in order to benefit from the reward effects related to penalty protection, to provide within the tax risk map, appropriate safeguards to identify, measure and manage the risks related to hybrid mismatches.

## Conclusions

In the light of the experiences developed in the field of transfer price documentation and patent box, the penalty protection regime for hybrid mismatches is aimed at pursuing a twofold objective: on the one hand, the Ministerial Decree introduces a favorable regime for the most virtuous taxpayers, thus incentivizing the keeping of correct and appropriate documentation in order to be granted the disapplication of penalties. On the other hand, the documentation produced by the taxpayer allows the tax administration to benefit from a significant information advantage, offered spontaneously and in advance by the taxpayer himself.

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*have adopted them and therefore would have reacted to the direct generation of the hybrid effect”.*

7 I.e. “a transaction that generates or can reasonably be expected to generate a significant hybrid mismatch” Article 1 of Ministerial Decree.

8 Defined, according to Art. 1 of the Ministerial Decree, as “the set of relevant transactions into during the same tax period with the same counterparty or different counterparties, whether they are associated enterprises or not, and which have the same or substantially the same legal and economic effects for the taxable person as the other relevant transactions in the same set, as well as the same treatment for the purposes of the Legislative Decree”.

9 As clarified by Article 1 of the Ministerial Decree, “for parties admitted to the collaborative compliance regime [...] the quantitative and qualitative materiality threshold agreed with the Internal Revenue Service related to a relevant transaction and the quantitative and qualitative materiality threshold agreed with the Internal Revenue Service related to a Homogeneous Group”.