Master’s Thesis International Business Taxation MSc

Tax Autonomy and Hybrid Mismatch Arrangements

Challenges to Tax Autonomy in an Era of
Conflicting Political Goals

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Table of Contents

List of Abbreviations and Acronyms

ATAD	Anti-Tax Avoidance Directive
BEPS	Base Erosion and Profit Shifting
BV	Besloten Vennootschap / *Private Company*
CC	Commercial Code / *Wetboek van Koophandel*
CEN	Capital Export Neutrality
CFC	Controlled Foreign Company
CFR	Code of Federal Regulations / US Administrative Law
CIN	Capital Import Neutrality
CIT	Corporate Income Tax
CITA	Corporate Income Tax Act
CJEU	Court of Justice of the European Union
CLC	Belgium Company Law Code
CV	Commanditaire Vennootschap / *Limited Partnership*
D/NI	Deduction/non-inclusion
DD	Double Deduction
DTA	Dividend Tax Act
EC	The European Commission
ECOFIN	Economic and Financial Affairs Council Configuration
EP	The European Parliament
EU	The European Union
GAAP	Generally Accepted Accounting Principles
GTA	General Tax Act
HMA	Hybrid Mismatch Arrangement
HRMC	Her Majesty's Revenu and Customs / *UK Tax Authorities*

IFRS	International Financial Reporting Standards
IP	Intellectual Property
IRS	Internal Revenu Service */ US Tax Authorities*
ITC	Belgium Income Tax Code
LLC	Limited Liability Company
LV	Landbouwvennootschap / *Under Belgium law incorporated Farming Company*
MC	Model Convention
MNE	Multinational Enterprise
NGO	Non-Governmental Organization
NOB	De Nederlandse Orde van Belastingadviseurs / *The Dutch Association of Tax Advisers*
NV	Naamloze Vennootschap / *Limited Company*
OECD	Organization for Economic Co-operation and Development
OECD BEPS Project	OECD and G20 Action Plan on Base Erosion and Profit Shifting
POEM	Place of Effective Management
PE	Permanent Establishment
PSD	Parent-Subsidiary Directive
RPS	Redeemable Preference Shares
SME	Small and Medium-Sized Enterprises
SNC	Société en Nom Collectif / *French Partnership*
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
UK	The United Kingdom
UN	The United Nations
US	The United States of America

Foreword

In the second half of the last century, international agreements led to States abolishing various protectionist measures, making space for an EU market without internal frontiers. Technological and logistical innovations, as well as the disappearance of cultural barriers contributed to the acceleration of the international mobility of people, goods, capital, and services. Nonetheless, this type of globalization has the consequence that States are less autonomous in exercising their tax jurisdiction, and external influences on a Member State's tax autonomy are becoming more perceptible. On the one hand, a Member State's tax autonomy is bound by legal sources such as international and EU law. On the other hand, non-legal factors, such as globalization, tax competition, technical developments and changing political, cultural and social insights, affect a Member State's tax autonomy as well.

For instance, catalyzed by the financial crisis, a strong international social and political movement has arisen against tax avoidance strategies that exploit gaps and mismatches in tax rules, often referred to as *Base Erosion and Profit Shifting*. This has led to coordinated actions in the OECD (mandated by the G20) and EU context, ensuring that profits are taxed where economic activities which generate these profits are performed and where value is created.

The question remains, however, how this movement relates to the Member States' prerogative to levy taxes within its jurisdiction, as many issues concerning a Member State's tax autonomy remain unsolved and undiscussed in literature and are not covered by the work of the OECD or the EC. Hence, with this thesis, I intend to stimulate the discussion concerning the potential infraction of a Member State's tax autonomy in the attempt to combat harmful tax practices on a supranational level.

This thesis concludes my International Business Taxation MSc curriculum, and is written within the context of the EUCOTAX WINTERCOURSE 2018. This course is covered by the central theme *Challenges to Tax Autonomy in an Era of Conflicting Political Goals*. As a representative of the Netherlands in Subtopic 4, I have written an initial paper concerning the impact of the measures against hybrid mismatch arrangements in BEPS Action 2 and the ATAD on the current Dutch tax legislation. This thesis will capitalize on the work of this paper.

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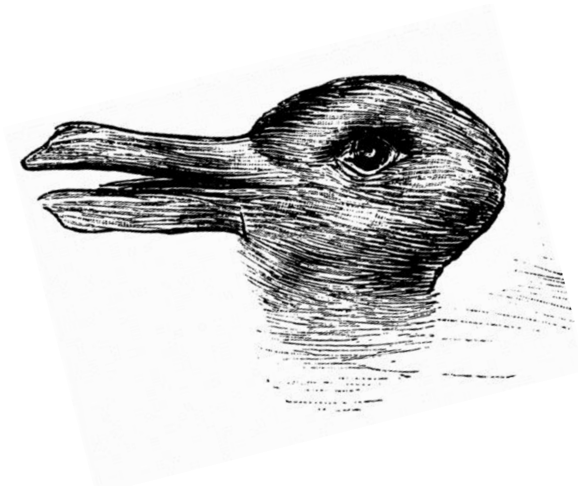
Preface

If you are not familiar with the illustration, you may wonder why I start this thesis with the sketch of a rabbit. Wait, you mean a duck, right? Well, that depends on your perception of the image. Look closer, and see if you can discern both animals.



“Kaninchen und Ente”, from the 23 October 1892 issue of *Fliegende Blätter.*

Most of us can flip at will between two dimensions. We might say: “Now it is a duck, and now it is a rabbit.” There is no good or bad, no right or wrong. What we see is determined by our way of looking at it; it all depends on our perception.

Different perceptions allow us to debate, to learn from each other, and to develop ourselves. Different views color the world around us and contribute to the outlook of our life. Yet, different visions may well be divisive as well, leading to clashes and conflicts, causing discord and opposition.

The author is occupied with the different views to the same substance that States may have in the field of international taxation. It is not the prior intent of the author to criticize a State’s perception. After all, if one sees a rabbit, while the other recognizes a duck, then who is actually wrong in its view? Yet, when different views cause conflicts, it is of paramount importance to manage these conflicts in the best way possible, preferably while respecting the view of both States involved. This thesis provides for an analysis of current conflicts due to different views and the proposed solutions related to these conflicting views. To the extent necessary, the author will do the utmost to provide for improvements for current and proposed systems that deal with these conflicting views in the field of international taxation.

1. Introduction and Problem Statement

From a tax autonomy perspective, a European Union (EU) Member State is, in principle,[1] free in the demarcation of the taxable object within its territory.[2] For example, a Member State could exercise its right to levy taxation on the basis of residency or source,[3] insofar as this does not breach EU law.[4] However, differences between the applied taxation principles among states may cause problems in cross-border situations. Given that different allocation principles coexist, double taxation might occur. Although this kind of double taxation is caused by the parallel exercise of the autonomous taxing right of two states, it does not diminish the fact that double taxation is considered an undesired phenomenon, as it hinders cross-border business activities.[5] Therefore, in most cases, double taxation is obviated (or at least reduced) by bilateral tax treaties, which arrange the allocation of the power to impose taxes between two states.[6]

However, disparities between tax systems may also be caused by two (or more) states qualifying a certain income component differently (*qualification conflict*) or classifying an entity in a distinct way (*classification conflict*). On balance, this can lead to double taxation as well, provoking a detrimental effect for the taxpayer involved.

Contrary to the aforementioned double taxation issues, qualification and classification conflicts may also result in a more favorable treatment for the taxpayer, as disparities could lead to double non-taxation. Differences in tax treatment under the law of two or more jurisdictions, which are intentionally exposed by the taxpayer (to produce a mismatch in tax outcomes, where the mismatch has the effect of lowering the aggregate tax burden of the parties involved), are described as hybrid mismatches or hybrid mismatch arrangements (HMAs).[7] HMAs are harmful for national governments, as they cause a distortion of competition and a loss of tax revenue.[8] Likewise, it has a negative impact on economic efficiency and leads to a lack of transparency.

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[1] Since the *Avoir Fiscal* case, the CJEU made it clear that Member States' tax rules are subordinated to EU law, and particularly to the freedoms of movement. See CJEU C-270/83, *EC vs French Republic*, par. 14.
[2] Member States remain largely free to design their direct tax systems so as to meet their domestic policy objectives and requirements. See COM (2006) 823 final, par. 1. Also, international juridical double taxation as a result of parallel exercise of fiscal sovereignty by two Member States – such as worldwide taxation by the residence State and source taxation by the source State on the same income of the same taxpayer – although a major obstacle to the exercise of the EU Treaty Freedoms, cannot be remedied by relying on those freedoms. See in particular CJEU C-513/04, *Kerckhaert Morres*, CJEU C-128/08, *Damseaux*, and CJEU C-67/08 *Block*.
[3] Or other principles with respect to the allocation of tax jurisdiction, such as nationality or citizenship, incorporation/siège reèl, origin, and functionality. For a more extended discussion of international allocation principles for the taxation of corporate income, see Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.3.1.
[4] CJEU C-279/93, *Schumacker*, par. 21.
[5] EC (2012). *Public consultation paper*. Problems that arise in the direct tax field when venture capital is invested across borders, p. 2.
[6] For a more extended explanation of the aim of tax treaties, see also: UN (2013). *Why Negotiate Tax Treaties.*
[7] OECD (2014). *Neutralising the Effects of Hybrid Mismatch Arrangements*. Action 2: 2014 Deliverable, par. 41, p. 29.
[8] OECD (2012). *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, p. 11.

In industrialized States, most corporate taxation models were designed in the first half of the 20th century, a period in which cross-border activity was limited. At the time when cross-border activities took place a local physical or legal presence was required.[9] Nonetheless, in today's world, multinational enterprises (MNEs) have become increasingly mobile under the influence of globalization. Their global activities and transnational structures grant access to every fiscal jurisdiction, causing an increasing capability of using HMAs to reduce their overall tax burden. In addition, their business models and corporate structures are more complex than how they were decades ago, making it easier for MNEs to shift their profits in order to erode their overall tax base.[10]

Manifestly, MNEs anticipate globalization more easily and faster than national tax authorities do, making HMAs more readily available for MNEs. Current taxation systems seem to be outdated and do not appear to be "resistant" to HMAs. This is also noted by international media, which is increasingly reporting on tax-saving arrangements and the "reputations" of MNEs.[11] From a social and political perspective, the consequences of HMAs are more and more perceived as objectionable. Nowadays, more value is given to the ethical aspect of paying taxes and, in effect, to contributing a fair share to society.

It is evident that no State can tackle this problem on its own.[12] National corporate tax systems differ from each other, and independent action would not eliminate inefficiencies and distortions in the interaction of separate national measures. Instead, due to the cross-border nature of HMAs, solutions may be found on international or supranational level. Hence, both the Organization for Economic Co-operation and Development (OECD) and the EU are seeking a defense against HMAs in the harmonization of domestic laws. Although, in first instance, the OECD labeled such an approach as merely theoretical,[13] it seems to be interpreted as a severe potential solution by the EU.[14]

1.1 Taxing Profits where Value is Created

Under the OECD Base Erosion and Profit Shifting Project (OECD BEPS Project), a single set of 15

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[9] EP (2015). *Draft report on tax rulings and other measures similar in nature or effect* (2015/1066(INI)), p. 8.
[10] The Commission Staff Working Document (SWD(2015) 121 final) provides a detailed overview of the historical development and the current issues and challenges in the taxation of multinational profits.
[11] See, for example, Kemmeren, E.C.C.M. (2014). *Where is EU Law in the OECD BEPS Discussion?* EC Tax Review, *23*(4), p. 190. We read: "Around the globe, a fierce discussion on BEPS is going on. The focus seems to be predominantly on actions of the business society reducing its corporate tax burden. Reputations of a number of MNEs are under discussion, also in the main press. I refer, e.g., to Starbucks, Google, Facebook, Ikea, the Rolling Stones and U2."
[12] EC (2017). *Council Directive amending Directive 2016/1164, as regards hybrid mismatches with third countries*, par. 27, p. 5 of the preamble.
[13] OECD (2012). *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, p. 13.
[14] See recommendation C6 of the Resolution of the European Parliament with recommendations to the Commission on bringing transparency, coordination and convergence to corporate tax policies in the Union, 16 December, (2015/2010 (INL)). We read that "The European Parliament calls on the European Commission to bring forward a legislative proposal to either harmonize national definitions of debt, equity, opaque and transparent entities, harmonize the attribution of assets and liabilities to permanent establishments, and harmonize the allocation of costs and profits between different entities within the same group; or prevent double non-taxation, in the event of a mismatch."

consensus-based actions is created to equip governments with domestic and international instruments to address tax avoidance, "*ensuring that profits are taxed where economic activities which generate these profits are performed, and where value is created.*"[15] One of these actions, BEPS Action 2, develops model provisions and recommendations regarding the design of domestic rules to neutralize the effects of HMAs.[16]

In response to the OECD BEPS Project, the EU Council has established the Anti-Tax Avoidance Directive (ATAD),[17] wherein the combat of HMAs plays a significant role.[18] The ATAD aligns some aspects of the different tax systems within the EU in order to exclude common forms of aggressive tax planning, which is essential for the efficient functioning of the internal market.[19] As well as under the OECD BEPS Project, the ATAD "*highlights the need for ensuring that tax is paid where profits and value are generated*."[20] Yet, it is not covered by the work of the OECD or the EU whether or how the recommendations respectively the measures against HMAs contribute to this guiding principle.

1.2 Tax Autonomy

Emanating from the Community's founding Treaties, EU Member States are obligated to integrate virtually all possible forms of EU legislation into their own legal systems.[21] Hence, all Member States shall implement the ATAD by the end of 2019 at the latest.[22] However, the ongoing negotiation process for the United Kingdom's (UK) exit from the EU, last year's Catalonia crisis, and the more recent budget dispute between Italy and the European Commission (EC) illustrate the importance of cautiously handling the right of self-determination. In an era where, within the EU's borders, autonomy itself seems to be cherished more than ever,[23] it is relevant to examine how the implementation of the ATAD relates to a Member State's right of

[15] OECD (2015). *Explanatory Statement.* OECD/G20 Base Erosion and Profit Shifting Project, p. 4.

[16] OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements*, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[17] EC (2016). *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market* (EU) 2016/1164.

[18] On February 21, 2017, the EU Member States reached agreement on an amendment of Article 9 of the Directive, which is now extended to include hybrid mismatches between EU Member States and third states. Unless otherwise stated, any reference in this thesis to the ATAD refers to the aggregation of both the ATAD before and after its amendment. See EC (2017). *Council Directive Amending Directive 2016/1164, as regards hybrid mismatches with third countries*.

[19] Such as interest limitation rules, controlled foreign company rules, exit taxation provisions and general anti-abuse rules. See in this respect EC (2016). *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market*, (EU) 2016/1164, par. 2, p. 1.

[20] EC (2016). *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market* (EU) 2016/1164, par. 1, p. 1.

[21] The CJEU first pronounced in the *Van Gend en Loos* judgment that the community constitutes a new legal order of international law for the benefit of which Member States have limited their sovereign rights. See CJEU C-26/62, part II.B., par. 4, *Van Gend en Loos vs. Netherlands Inland Revenu Administration*: "un nouvel ordre juridique de droit international au profut duquel les Etats membres ont limité leur pouvoirs souverains". These words have been then used slightly differently in *Costa vs. E.N.E.L.*, when the CJEU added that "by contrast with ordinary international treaties, the EEC Treaty has created its own legal system". See CJEU C-6/64 par. 12, *Costa vs. E.N.E.L.*: "un ordre juridique propre".

[22] Except for one specific provision. By way of derogation of the other provisions, Member States shall, by 31 December 2021, adopt and publish the laws, regulations and administrative provisions necessary to comply with Article 9a of Directive (EU) 2016/1164. See EC (2017). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164, Article 2, par. 3.

[23] The aspiration for independence is of relevance in more EU regions such as Scotland, which is part of the UK and thus will leave the EU as a result of Brexit. This while a majority of the Scots voted against the departure from the EU. Other examples of regions where the call for

self-determination in the field of taxation.

Although the OECD claims that its actions "*are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income*",[24] BEPS Action 2 and the ATAD appear to reveal otherwise. Indeed, the measures against HMAs demonstrate that existing international tax rules are actually being reassessed and reformed by introducing mandatory provisions which can impose the refusal of inclusion or deduction of a payment in a taxpayer's ordinary income.[25] A Member State's exclusive power to execute its fiscal jurisdiction might be restricted when enforcing the ATAD. In this light, maintaining tax autonomy and combating harmful tax planning seem to be contradictory elements,[26] and the implementation of the ATAD might well detract from the tax autonomy of a Member State. While in former times, tax systems were largely observed in the context of a single and sovereign jurisdictions, unaffected by tax systems outside their borders,[27] as a matter of fact, that same sovereignty seems to be eroded by introducing the ATAD.

1.3 Developing a Research Question

Having established the main framework of this thesis, the research question can be substantiated. This research question consists in a *descriptive* aspect, a *normative* aspect, a *comparative* aspect, and a *contemplative* aspect.

1.3.1 Descriptive Aspect

Given the limited length of this thesis, its focus lies on the Dutch tax system, and adds a touch on the Dutch political thoughts about the OECD BEPS Project and the ATAD with regard to anti-hybrid measures. For this reason, the Dutch tax system with regard to HMAs is described in detail. The author will not dwell upon other States' tax systems in a detailed and in-depth manner. Other States' tax systems will only be considered to the necessary extent for comparative purposes.

independence affect the political agenda to a certain degree are Flanders, Northern Italy (see in this respect the Lega Nord party), Corsica, Kosovo (which is not recognized as an autonomous State by five Member States, but instead as being part of Serbia) and Northern Ireland.

[24] OECD (2013). *Action Plan on Base Erosion and Profit Shifting.* OECD Publishing, Paris, p. 11.

[25] Smit notices these developments under the three main institutions of the EU: the European legislator, the CJEU, and the EC. See in this respect Smit, D.S. (2017). *International Income Allocation under EU Tax Law: Tinker, Tailor, Soldier, Sailor.EC Tax Review*, *26*(2).

[26] Allison Christians, T.A.P. (2008). *Sovereignty, Taxation, and Social Contract*, Minnesota Journal of International Law, p. 3. According to Christians, the "Harmful Tax Practices"-project has let [the OECD] to articulate a version of sovereignty that prioritizes responsibility to the international community over the individual autonomy of nations.

[27] Musgrave, P.B. (2006). *Combining Fiscal Sovereignty and Coordination*. The new public finance: Responding to global challenges, p. 167.

1.3.2 Normative Aspect

The normative aspect of this thesis provides for a benchmark in which the concept of tax autonomy will be expressed in the light of international allocation principles for the taxation of corporate income. In this respect, emphasis lies on the guiding principle of the OECD BEPS Project – to ensure that taxation takes place where economic activities generate profits and value is created – wherein attachment will be found to the *concept of source country entitlement*.[28]

1.3.3 Comparative Aspect

The EUCOTAX WINTERCOURSE 2018 assembly in Edinburgh – covered by the central theme *Challenges to Tax Autonomy in an Era of Conflicting Political Goals* serves as a basis for the legal comparison. A national paper based on Subtopic 4: *Tax Autonomy and Hybrid Mismatches, Reversed Hybrid Mismatches, and Tax Residency Mismatches under the Anti-Tax Avoidance Directive* was produced by representatives from the Wirtschaftsuniversität Wien, Austria; the Katholieke Universiteit Leuven, Belgium; the Université Paris 1 Panthéon – Sorbonne, France; the Universität Osnabrück, Germany; the Corvinus University of Budapest, Hungary; the LUISS Guido Carli, Italy; the Tilburg University, the Netherlands; the University of Lodz, Poland; the Universitat de Barcelona, Spain; the Uppsala University, Sweden; the University of Zurich, Switzerland; the University of Edinburgh, UK; and the Georgetown University of the United States of America (US). The Netherlands' tax system and its political view the ATAD regarding hybrid mismatches is described and subsequently compared to the approaches in the mentioned States.

1.3.4 Contemplative Aspect

The aim of this thesis is to evaluate whether the ATAD regarding the combat of HMAs contributes to the guiding principle of the OECD BEPS Project, that is to say where profits are taxed where economic activities take place and value is created. At the same time, the impact of the implementation of the ATAD will be measured against international allocation principles for the taxation of corporate income to assess its impact on a Member State's tax autonomy.

[28] Smit, D.S. (2017). *International Income Allocation under EU Tax Law: Tinker, Tailor, Soldier, Sailor.EC Tax Review*, *26*(2), p. 68. With reference to EC (1992). *Report of the Committee of Independent Experts on Company Taxation*, p. 32 and p. 37.

1.3.5 Research Question

The following research question will be guiding in this thesis:

To what extent are the anti-hybrid measures of the Anti-Tax Avoidance Directive pursuing the guiding principle of the OECD BEPS Project as expressed by the concept of source country entitlement and how does the implementation of the Anti-Tax Avoidance Directive influence international allocation principles for the taxation of corporate income?

1.4 Research Design

This thesis evaluates the impact of the anti-hybrid measures of the ATAD on a Member State's international allocation principles for the taxation of corporate income – videlicet whether the ATAD respects a Member State's tax autonomy – and addresses the question whether these measures reflect the guiding principle of the OECD BEPS Project. The research question, as developed in the previous section, will be elaborated upon and answered through the course of the thesis. The following steps will be taken to provide an answer:

(i) In *Chapter 2*, the technical aspects of different types of HMAs will be considered from a descriptive point of view. By doing so, the current situation (*i.e.* the Dutch tax system in where HMAs still appear and the ATAD has not yet been implemented) will be set out, after which the negative effects of the occurrence of HMAs are briefly discussed.

(ii) Having insights into the occurrence of HMAs, *Chapter 3* will develop the normative framework of this thesis, where the concept of tax autonomy will be expressed in the light of international allocation principles for the taxation of corporate income. Specific reference will be made to the guiding principle of the OECD BEPS Project.

(iii) The stated objective of the anti-hybrid measures of the ATAD is "*to neutralize the effects of HMAs by providing rules consistent with (…) the BEPS conclusions*."[29] In order to understand the purpose and intent of the anti-hybrid measures of the ATAD, it is relevant to examine its predecessor. Hence, *Chapter 4* deliberates on the ambitions and technical aspects of BEPS Action 2. Some political thoughts on BEPS Action 2 are considered from a Dutch point of view.

[29] EC (2016). *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, (EU) 2016/1164*, par. 2, p. 1.

(i) The question of the extent to which the ATAD influences a Member State's international allocation principles for corporate income will be assessed in *Chapter 5*, where the guiding principle of the OECD BEPS Project will be analyzed from a contemplative point of view by assessing different types of HMAs. The Consultation Document for the implementation of ATAD measures regarding HMAs (hereinafter: Consultation Document), issued by the Dutch Ministry of Finance cannot be disregarded in this chapter.

(ii) Having assessed the impact of the ATAD on international allocation principles for the taxation of corporate income, a comparative analysis of the EUCOTAX WINTERCOURSE countries will be provided for in *Chapter 6*. The impact of the anti-hybrid measures of the ATAD is considered in this chapter.

(iii) Final conclusions and recommendations will be drawn up in *Chapter 7*.

1.5 Delimitation

The OECD BEPS Project in its broadest sense addresses tax avoidance strategies by MNEs. In response, its EU transposition is comprised of several operative components, from interest limitation rules to controlled foreign company rules, and from exit taxation provisions to general anti-abuse rules. This thesis shall not provide for an analysis of the OECD BEPS Project as a whole, but solely focus on the HMAs as mentioned in BEPS Action 2. Similarly, unless otherwise mentioned, any reference in this thesis to the ATAD refers to the ATAD-provisions against HMAs.

As it will be shown, HMAs can appear in different forms. The broad definition of HMAs in the ATAD covers hybrid entity mismatches, hybrid financial instrument mismatches (including hybrid transfers), hybrid permanent establishment (PE) mismatches, tax residency mismatches and imported mismatches. For feasibility reasons, not all of them will be discussed. Hybrid transfers and imported mismatches fall outside the scope of this thesis.

A hybrid transfer is defined as any arrangement to transfer a financial instrument, wherein the underlying return on the transferred instrument is treated, for tax purposes, as derived simultaneously by more than one of the parties to the arrangement.[30] Provided that there is only one underlying payment, however, the economic benefit of that payment will be shared between the parties under the terms of the hybrid transfer.

[30] EC (2016). *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market*, (EU) 2016/1164 par. 23, p. 4.

The OECD recommendations regarding hybrid transfers are mainly focused on repurchase transactions (repos), which are generally the result of complex banking structures. Due to its complexity and its specific character, hybrid transfers will not be discussed in this thesis.

An imported mismatch is not considered to be a hybrid mismatch in itself. It finds its origin in another hybrid mismatch. An imported mismatch shifts the effect of a hybrid mismatch between parties in third States into the jurisdiction of a State through the use of a non-hybrid instrument within the framework of a structured arrangement, thereby undermining the effectiveness of the rules that neutralize hybrid mismatches.[31] Since an imported mismatch solely reflects the technique of shifting the effects of a hybrid mismatch into another jurisdiction, it will not be discussed in this thesis. Moreover, any mismatch outcome, whose nature corresponds to an imported mismatch, such as a PE mismatch with an indirect deduction/non-inclusion outcome,[32] is in the same manner excluded from the scope of this thesis. Any other kind of mismatch, such as timing issues and the treatment of rules for taxing and relieving payments according to different bases are disregarded in this thesis as well.

1.6 Methodology

In this thesis, the underlying question is whether or not the ATAD meets the guiding principle of *taxation where the value is created*, and, consequently, how the implementation of the ATAD influences the international allocation principles for the taxation of corporate income. More specifically, and in accordance with the main theme of the EUCOTAX WINTERCOURSE 2018 – *Challenges to tax autonomy in an era of conflicting political goals* – the ratio between two legal orders of law is unveiled. This involves finding the right balance between a supranational movement against HMAs and the preservation of the national fiscal sovereignty of an EU Member State. Hence, a legal-dogmatic approach appears to be the most appropriate research method.[33]

[31] *Ibid*. par. 25, p. 5. See also Allen, C. (2017), *The Difficult Imported Mismatch Rules: BEPS Action 2 Recommendations*, 19 Derivs. & Fin. Instrums. 6, Journals IBFD.
[32] OECD (2017). *Neutralising the Effects of Branch Mismatch Arrangements*. Action 2: Inclusive Framework on BEPS, p. 49 – 52.
[33] Vranken states that "*legal-dogmatic research concerns researching current positive law as laid down in written and unwritten European or (inter)national rules, principles, concepts, doctrines, case law and annotations in the literature.*" See Vranken, J. (2012). *Exciting Times for Legal Scholarship*. Recht en Methode in onderzoek en onderwijs, p. 43.

2. Hybrid Mismatch Arrangements

Hybrid mismatches are caused by the autonomous application of different fiscal qualification or classification methods among States (without considering the tax classification of the other State). On balance, this may result in a more favorable treatment of the taxpayer, as disparities could lead to double non-taxation. When differences in tax treatment under the law of two or more jurisdictions are intentionally[34] exposed by the taxpayer (to produce a mismatch in tax outcomes, where the mismatch has the effect of lowering the aggregate tax burden of the parties involved), we make reference to an HMA.[35] In this chapter, the occurrence of hybrid mismatches due to hybrid entities and reverse hybrid entities will be discussed in section 2.1, and section 2.2, respectively. Hybrid financial instruments will be addressed in section 2.3. Subsequently, although it is not part of the initial EUCOTAX paper, the author will briefly elaborate upon PE mismatches in section 2.4. Finally, tax residency mismatches will be explained in section 2.5, and, last but not least, in section 2.6, the effects of HMAs will be examined, after which a conclusion will be drawn up in section 2.7.

Every section includes one or more paragraphs in which the occurrence of the aforementioned HMAs will be discussed on the basis of general examples. Where applicable, the subsequent paragraphs will make reference to present-day legislation under the Dutch tax system. This chapter was referred to as the *descriptive* aspect of this thesis in *Chapter 1*.

2.1 Hybrid Entity Mismatch

Typically, domestic civil laws provide several different legal forms, so that entities can engage in business activities. A State is in this respect autonomous with regard to the determination of the applicable character traits for a particular legal form. Accordingly, States are autonomous while classifying foreign entities, by determining the national legal type of entity that corresponds to that foreign entity.

In corporate income taxation (CIT), entities can be held liable to tax as a taxable subject, but only when classified as a non-transparent legal entity. However, domestic tax law may also be applicable to businesses which are not taxable subjects by itself (due to the absence of legal personality). These businesses are considered to be transparent, meaning that taxation takes place at the level of the persons participating in this entity. This can be the case in the Netherlands, where profits of certain business types are subject to tax

[34] The anti-HMA measures to be discussed do however disregard the intention of the taxpayer. See section 4.1.2 and section 5.2.2.2.
[35] OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements,* Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 11.

at the level of the participants, and not at the level of the entity itself.[36] Hence, to determine the taxable subject for CIT, it is essential to understand the classification of the business form.

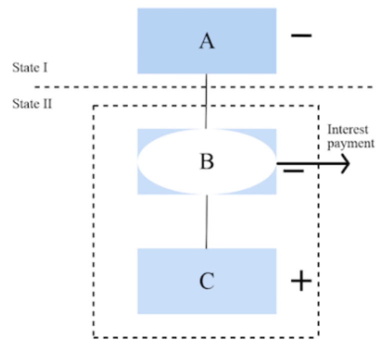
In essence, hybrid entities are legal structures which are classified differently under the legislation of two or more States. As a result, a classification conflict occurs, whereby the State where the participants reside considers the entity as tax transparent, while the other State considers the same entity as non-transparent for tax purposes (unlike the reverse hybrid entity, which is the exact opposite situation, compare section 2.2). The substantial difference is that tax transparency leads to taxation at the level of the participants, while having the classification of a non-transparent (or opaque) entity means that taxation takes place at the level of the entity itself. Thus, if an entity is designated as transparent, the entity itself is not taken into account for tax purposes. Instead, the income of the entity is directly attributed to the underlying participants of this entity. In such a case, the income component is subject to tax only at the level of the participants, and not at the level of the entity itself.[37] A subsequent payment of income by the transparent entity is ignored for tax purposes as it is considered to be a transfer of previously taxed amounts.[38] If an entity is classified as non-transparent, it is considered as an independent legal entity with legal personality. Taxation of such a non-transparent entity, therefore, takes place at the level of the entity itself, and thus not directly at the level of the underlying participants.[39]

As soon as two States do not classify an entity in the same way, a hybrid entity mismatch might occur, which could lead to a double deduction outcome (DD outcome), where a deduction is claimed for the same amount in two States; or a deduction/non-inclusion outcome (D/NI outcome), where a deduction in one State is not offset by the inclusion of an amount of income in another State.[40] A DD outcome occurs when deduction takes place in both of the States involved for the same cost component. In case of a D/NI outcome, the deduction of costs takes place in the one jurisdiction, while there is no corresponding taxation in the other State. The following examples will clarify the functioning of HMAs with regard to hybrid entities for both DD outcomes and D/NI outcomes.

[36] The 'open commanditaire vennootschap', 'vennootschap onder firma', and the 'maatschap', are examples of transparent entities, governed by Dutch law.
[37] When taxation only takes place at the level of the participants, Barenfeld speaks of a "single-tax pattern". See Barenfeld, J. (2005). *Taxation of cross-border partnerships: double tax relief in hybrid and reverse hybrid situations* (Vol. 9). Ibfd, par. 3.4.3, p. 98.
[38] OECD (1999). *The Application of the OECD Model Tax Convention to Partnerships*, par. 135, p. 49.
[39] Barenfeld speaks of a "double-tax pattern" when the income is partly taxed at the level of the entity, and partly taxed at the level of the participants as soon as the income is distributed to the latter. See Barenfeld, J. (2005). *Taxation of cross-border partnerships: double tax relief in hybrid and reverse hybrid situations* (Vol. 9). Ibfd, par. 3.4.2, p. 93.
[40] OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements*, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 7 – 8, p. 17.

2.1.1 Double Deduction[41]

Suppose that the entities A, B, and C are associated enterprises. Entity B is considered to be a non-transparent entity in State II, while it is considered to be transparent from the perspective of State I (hybrid entity). Entity B obtains an interest-bearing loan, issued by a third party. Since entity B is considered to be transparent by State I, the interest costs arising from the third-party loan are attributed to the participant(s) of entity B; entity A, situated in State I. The latter State, therefore, grants a deduction to entity A for the interest paid.



However, as entity B is considered to be a non-transparent entity by State II, these same interest costs arising from the third-party loan are attributed to entity B by State II as well. Deduction of interest now takes place twice; (1) once at the level of participant A in State I, and (2) once at the level of entity B in State II.

The deduction of interest costs, incurred at the level of entity B, can only reduce the tax burden if there is a profit from which the costs can be offset. However, insofar entity B generates profits, these profits will follow the same pattern as the incurred interest costs. Once again, these profits are taxed twice just as the interest costs are deductible twice, resulting in the effectuation of the mismatch. Yet, due to an applicable tax group regime[42] between entity B and entity C, profits and losses can be consolidated among these entities, as if they were one single taxpayer. Hence, the interest costs can be set off against a profit (made by entity C), even if the profit of entity B itself is nil, and thus be deducted twice. Unlike the occurred interest costs, the profit made by entity C is not recognized by entity A as the latter does not participate in the group tax regime. In other words, the hybrid entity is structured in such a way that it will never generate a net profit (mitigating other facts and circumstances). This ensures that there is never a sufficient *dual inclusion income* to eliminate the mismatch generated by the duplicate deduction.[43]

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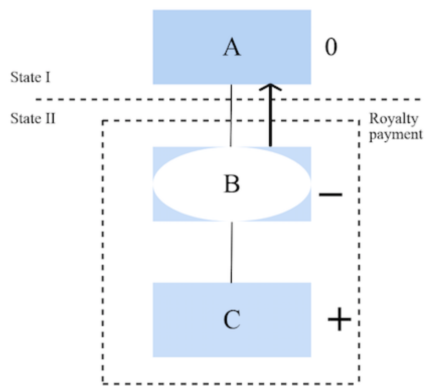
[41] EC (2016). *Proposal for a Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164, p. 6.
[42] A tax group regime is adopted in tax legislation by a number of States which treats a group wholly owned or majority-owned companies and other entities as a single entity for tax purposes. For an overview of the various tax consolidation regimes in the EU, see Reijn, Z.N., Van de Voorde, N. & Van der Zeijden, F.M. (2018). *Tax Grouping in an EU Context: All Roads Lead to Brussels*, 58 Eur. Taxn. 7,Journals IBFD.
[43] OECD (2014). *Public discussion draft BEPS Action 2: neutralize the effects of hybrid mismatch arrangements* (Recommendations for domestic laws), p. 46.

2.1.2 Deduction/Non-Inclusion[44]

Suppose again that entities A, B and C are associated enterprises. Hybrid entity B is again considered to be non-transparent from the perspective of State II, but is considered to be transparent from the perspective of State I. A royalty payment is made from entity B to entity A. As State II considers hybrid entity B as non-transparent, it allocates the royalty payment to B. The payment by B is being set-off against the income of C under a group tax regime in State II. State I, however, does not include the royalty income in the tax base of A, since it does not recognize the royalty payment made by B to A. Indeed, State I considers entity B as being transparent, and thus allocates the royalty payment as being made by entity A. However, since A is the recipient of this same payment, no transaction is recognized. After all, one cannot enter into a transaction with itself. Consequently, the royalty payment is now deducted by B, and set-off against the income of C, without a corresponding recognition of royalty income by entity A.



2.1.3 The Netherlands Classification of Domestic Entities

The Netherlands levies CIT from entities recognized as taxpayers under the Corporate Income Tax Act 1969 (*Wet op de Vennootschapsbelasting 1969*, hereinafter CITA). The treatment of domestic entities[45] as either transparent or non-transparent for CIT, depends on an explicit reference to a number of different legal forms recognized in the Netherlands' civil law. Domestic entities are non-transparent, and therefore liable for CIT if they are explicitly listed in Article 2, paragraph 1, of the CITA. Domestic entities are entities incorporated under the Netherlands civil law. In the following sub-paragraphs, the most important Dutch domestic entities will be briefly discussed.

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[44] EC (2016). *Proposal for a Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164, p. 7.

[45] For the sake of clarity, note that for the purpose of this thesis, domestic entities are entities incorporated under Dutch civil law. The author does not intend to point out the distinction between domestic and foreign taxpayers. The latter two terms intent to distinguish between resident entities of the Netherlands or, respectively, not being established in the Netherlands, while still generating income which has an allegiance with the Netherlands' territory. This distinction is of importance in order to determine whether an entity should be taxable for its worldwide income or, contrary, for the income that has a nexus with the Netherlands territory. See in this respect Article 2 and 3 of the CITA 1969.

2.1.3.1 Public Company, Private Company, and open Limited Partnerships (sub-paragraph a)

A public company (*naamloze vennootschap, NV*) is defined as an entity with legal personality whose share capital is divided into transferable shares.[46] Shareholders are not personally liable for the NV's obligations and, therefore, are not obliged to contribute with additional capital in the case of a deficit due to losses.

A private company (*besloten vennootschap,* BV) with limited liability (or just private company) is a legal entity which also has a capital divided into one or more transferable shares. This legal form is mostly in line with the characteristics set for the public company. The main difference lies in the fact that the private company may only issue registered shares.

According to Dutch civil law, a limited partnership (*commanditaire vennootschap, CV*) is considered to be a separate entity, but is generally not regarded as an independent taxpayer for CIT purposes. An exception is made, however, for companies that are largely comparable with the NV and the BV. The open limited partnership (*open commanditaire vennootschap, open CV)* is of particular relevance, and is defined as a limited partnership in which, except for transfers by inheritance or bequest, the admission or replacement of limited partners can occur without the (prior) consent of all limited and managing partners.[47] As proclaimed by the Netherlands' Supreme Court (*Hoge Raad*), this requirement is even met if the consent of only one or a few partners, but not all partners, is fulfilled.[48] This so-called *permission-requirement* should be incorporated in the agreement of the limited partnership, and the partners involved should act accordingly. The open CV has a hybrid character for CIT purposes since its status as a separate taxpayer is limited to the part that can be assigned to the limited partners. General partners in an open or closed Dutch limited partnership are taxed directly for their own account.

2.1.3.2 Cooperatives and other Associations based on the Cooperative Principle (sub-paragraph b)

The cooperative (*coöperatie*) is an association set up by notarial deed.[49] According to the articles of association, a cooperative must aim to provide for certain material needs of its members and must exercise its business on behalf of the members. As a general rule, those who are a member at the time of the dissolution of the cooperative, or who were a member less than a year ago, are liable for shortages or losses of the cooperative. Without further regulation in the articles of association, all members are liable for equal shares.

[46] Article 2:64, par. 1 of the Dutch Civil Code.
[47] Article 2, par. 3 of the General Tax Act.
[48] Supreme Court 27 February 2009, No. 43.388, BNB 2009/120.
[49] Article 2:53, par. 1 of the Dutch Civil Code.

2.1.3.3 Mutual Insurance Companies and other Associations which act as Insurance or Credit Organizations on the Principle of Mutuality (sub-paragraph c)

A mutual insurance society (*onderlinge waarborgmaatschappij*) is an association incorporated by notarial deed as well.[50] The statutory objective must entail that the mutual insurance company enters into insurance contracts with its members. The liability rules of the members are the same as those of the cooperative.

2.1.3.4 Building Corporations (sub-paragraph d)

A building corporation is an association or foundation that focuses on building, managing and renting quality housing with affordable rent for people with lower incomes. As of January 2008, an integral tax liability applies for building corporations.

2.1.3.5 Associations with or without Legal Personality and Foundations as well as Legal Persons other than Legal Persons under Public Law to the Extent that they Conduct a Business (sub-paragraph e)

An association (*vereniging*) is formed by a legal act of two or more members.[51] In general, the formation is effectuated through a notarial deed, but this is not necessarily required. An association is not allowed to distribute profits to its members.

A foundation (*stichting*) is a legal entity without members.[52] It uses its designated equity to affect its purpose set out in the articles of incorporation. The statutory purpose shall not include making payments to the founders, members of the foundation's bodies or others, unless those payments to the latter have an idealistic or social tendency. If a pension fund is incorporated as a foundation, pension payments to the founders, members of the foundation's bodies or others from former employment are not restricted. A foundation is incorporated through a notarial deed.

The other fragment of Article 2, paragraph 1, sub-paragraph e can be seen as a residual category of taxpayers. All legal entities that are not governed by public law are designated as potential subject to tax if they have not been included in the previous sections. An additional condition is that the legal entity in question must conduct a business.

2.1.3.6 Funds for Joint Account (sub-paragraph f)

Funds for a joint account (*fonds voor gemene rekening*), *e.g.* investment funds, are non-legal entities. A fund for a joint account is defined as a fund which purpose is to obtain profits for the benefit of its participants

[50] *Ibid*. par. 2.
[51] Article 2:26, par. 1 of the Dutch Civil Code.
[52] Article 2:285 of the Dutch Civil Code.

by means of investing for a joint account, provided that the participants' entitlements to the proceeds are marketable. The entitlement is deemed marketable if the disposal of the entitlement, or part of it, does not require the consent of all other participants of the fund. If the entitlement can only be transferred to the fund itself or to the spouse or relatives in the direct line of consanguinity, the entitlement is deemed non-marketable.

2.1.3.7 Business Activities in Relation to Classification as a Taxable Entity

Besides the foundation and the association, all other entities are deemed to conduct their business activities by exploiting their total asset base.[53] Consequently, all their income is taxable under the CITA. Foundations and associations are liable to the Netherlands CIT if business activities are conducted. Hence, foundations and associations are only partially liable to CIT. Separate rules for business activities conducted by public bodies also exist, but in general, these activities are not liable to tax; there are, nevertheless, certain specified businesses conducted by public legal entities which are regarded as taxable entities.[54]

2.1.4 The Netherlands' Classification of Foreign Entities

Foreign entities are entities which are not incorporated under Dutch civil law. The treatment of foreign entities as either transparent or non-transparent for CIT, depends on the legal characteristics of the entity in question.

Guidance in this respect can be obtained from case law. The approach of the Dutch Supreme Court is considered to be (roughly) reflected in a decree published by the Ministry of Finance which sets out the relevant criteria.[55] In the following lines, the relevant case law and the decree will be discussed.

2.1.4.1 Supreme Court Criteria 1 – the Entitlement of Profits and losses

The first criterion followed by the Supreme Court is to assess whether a foreign entity is linked with the entitlement of profits and losses of business activities conducted by the entity. In other words, the Supreme Court analyzes who owns the rights and obligations arising from the business and, hence, who is entitled to the profits.[56] The Supreme Court appears to make this assessment by applying two sub-criteria.[57] The first one consists in analyzing the extension of the participant's liability, in order to determine whether the liability is limited to their (capital) contribution in the entity.[58] The second criteria investigates whether the

[53] Article 2, par. 5 of the CITA 1969.
[54] *Ibid*. par. 1, sub g.
[55] 11 December 2009, *Staatscourant*, 2009, 19749.
[56] Supreme Court 31 December 1924, B. 3569 and 7 June 1939, B. 6925.
[57] Supreme Court 2 June 2006, No. 40.919, BNB 2006/288.
[58] Supreme Court 23 September 2011, No. 10/03724, BNB 2012/12.

business is legally owned by the entity or if it is not actually being conducted on the account and at the risk of the participants in any other way.

2.1.4.2 Supreme Court Criteria 2 – Transferability of the Participation

In case that one concludes that the rights and obligations arising from the business are owned by the entity, then this entity will be considered as an entity for Dutch CIT purposes. Such a taxable entity will be considered to be a non-transparent entity if its capital is wholly or partly divided into shares.[59] However, when the participants are directly entitled to the profits, then, a second test may apply in order to assesses whether the articles of association or agreement imposed on the relationship between the entity and the participants, resemble those of a partnership with a capital company (*kapitaalvennootschap*) or to a partnership (*personenvennootschap*). For the application of the CITA, a capital company is by definition non-transparent, while, in principle, a partnership is transparent, unless the relevant partnership must be interpreted as a capital company pursuant to Article 2, paragraph 3, sub-paragraph c, of the of the Dutch General Tax Act (*Algemene Wet inzake Rijksbelastingen,* hereinafter GTA). The decisive criterion in this respect is whether the participation in the entity is freely transferable.

2.1.4.3 The State Secretary Degree – Overview

The decree of the Dutch State Secretary uses a slightly different method than the one applied by the Netherlands Supreme Court. This decree includes a framework, consisting out of four questions, in which it is assessed whether a foreign entity should be regarded as a transparent or as a non-transparent entity for CIT purposes. On the basis of civil law of the foreign State involved, the articles of association or agreement of the foreign entity and the Dutch legislation, it is first assessed whether, from a Dutch perspective, a foreign entity corresponds to a capital company or to a partnership. By assessing the classification of an entity, four questions are of importance.

(i) Is the foreign entity able to have legal ownership?

(ii) How is the liability of the participants regulated?

(iii) Does the foreign entity have capital divided into shares?

(iv) Is the participation in the entity freely transferable?

2.1.4.4 The State Secretary Degree – Legal Ownership

It is assumed that the foreign entity has legal ownership when it can enter into rights and obligations, and when it is able to acquire assets under civil law.

[59] Supreme Court 16 March 1994, No. 27.764, BNB 1994/191.

2.1.4.5 The State Secretary Degree – Liability of the Participants

It is important to assess whether the participants have limited liability for the debts and other obligations of the foreign entity. In this respect, the limited liability of a participant means that the liability does not extend beyond the capital invested.

2.1.4.6 The State Secretary Degree – Capital Divided in Shares

Does the foreign entity have a capital divided into shares from a civil law perspective, or could the entities' capital be equated with capital divided into shares? If the capital of the foreign entity is divided into equal or proportional parts (participation), which give entitlement to a proportional part of the profit- and liquidation payment as well as it gives proportional control in the company, the capital will be equated to capital divided into shares.

2.1.4.7 The State Secretary Degree –Transferability of the Participations

When it is possible (aside from the case of inheritance or legacy) to join or replace a participant without the consent of other participants, the participation is deemed to be freely transferable.[60]

2.1.4.8 The State Secretary Degree – Transparent or non-Transparent

A foreign entity is considered to be a capital company and thus a non-transparent entity if three out of four questions of the assessment framework are answered in the affirmative. In the case that after assessing the criteria set out in the framework, it is concluded that the assessed entity cannot be considered as a capital company, then the foreign entity will be, in principle, considered to be a partnership and in this sense, a transparent entity for CIT purposes. Nevertheless, it is still necessary to assess whether the foreign entity corresponds to an (open) limited partnership (*open CV*), which in itself is partly treated as a transparent and partly as non-transparent entity under the domestic tax laws of the Netherlands, as explained in the final paragraph of section 2.1.3.1. If this question is answered in the negative, the foreign entity will be classified as a partnership and, therefore, as a non-transparent entity.

A foreign entity is comparable with an (open) limited partnership as known under Dutch legislation if the entity has the following characteristics.

- A business is engaged in the name of the legal entity; and
- there is at least one *managing partner* and one *limited partner*; and
- the managing partner is liable to third parties without restrictions or for an equal part; and

[60] To determine whether a participation is freely transferable, the articles of association or the agreement must be assessed against the content of the decision of 11 January 2007, no. CPP2006 / 1869M.

- the limited partner is only legally liable up to a maximum of the amount of capital paid; and
- the limited partner does not perform any external acts of management or administration; and
- the foreign entity has no capital divided into shares.

If the characteristics of the foreign entity corresponds to those of a Dutch limited partnership (*CV-achtige*), then it must be assessed whether there is an open- or restricted limited partnership by answering the last question of the above-mentioned framework (*i.e.* is the participation in the entity freely transferable?). When this question is positive answered, the foreign entity falls under the category of non-transparent entities.

Finally, if the foreign entity does not correspond to an (open) limited partnership, it must be assessed on the basis of the answers to question *iii* and *iv* of section 2.1.4.3, and on the basis of the judgment of the Dutch Supreme Court,[61] whether the foreign entity participates as a capital company in economic transactions. This will usually be the case if the capital invested by the participants is divided into shares, where the shares are freely transferable. If this is the case, the foreign entity will be classified as a non-transparent entity.

2.1.4.9 Additional Remarks

A list of foreign entities is published by the Dutch Ministry of Finance.[62] This list contains examples of foreign entities that have been reviewed and assessed by the Dutch tax authorities. This list is purely indicative, as the assessments of the entities have been conducted according to the civil legislation of the State of incorporation involved, supplemented by the articles of association or the cooperation agreement. Furthermore, given that the legislation of the foreign State could be subject to amendments, it would be possible that a new assessment will differ from an assessment previously published by the tax authorities on its website.

It is of utmost importance to highlight that by qualifying a foreign entity, it is of no relevance whether a foreign entity is considered as a taxable subject in the other State.[63] Moreover, there is no such thing as an optional system in the Netherlands that offers domestic or foreign entities a choice between being treated as transparent or non-transparent. However, in practice, due to the hybrid character of the limited partnership (compare section 2.1.4.8), the taxpayer has the choice with regard to the tax treatment of the limited partner. This is, however, the exception to the rule that there is no optional system.

[61] Supreme Court 24 November 1976, no. 17998.
[62] See https://download.belastingdienst.nl/belastingdienst/docs/lijst_gekwalificeerde_buitenlandse_samenwerkingsverbanden_dv0301z3pl.pdf.
[63] Court the Hague 14 July 1981, no. 23/81, BNB 1982/264.

Last but not least, it is noteworthy to mention that there is no specific system for an advance ruling, dealing with transparency or non-transparency in the Netherlands. Nevertheless, it is part of the general approach of the Dutch tax authorities that legal certainty shall be given by the tax inspectors in *bona fide* cases; the Dutch State Secretary takes the position that no certainty is preceded with regard to the use of hybrid entities, if it is probable that tax saving is the decisive motive.[64]

2.1.5 Other Classification Methods

Each State has its own legislation and jurisprudence with regard to the classification of foreign entities. In essence, hybrid entity mismatches occur due to the parallel exercise of a different classification method, or due to the parallel exercise of the same classification method by different national legislations of two (or more) States. In general, there are four different approaches to the classification of foreign entities that a State can adopt.[65]

2.1.5.1 Similarity Approach

As in the Netherlands, most other States use the *similarity approach* for the classification of foreign entities.[66] The basic idea behind this approach is the resemblance test, where the legal characteristics of the foreign entities are compared with those of domestic entities. The legal form under domestic law that most closely resembles the foreign entity is considered to be applicable to the foreign entity for tax purposes.[67] The classification could differ from the one that is applied in the foreign State where the entity is located, and hence, there could be consequences regarding the allocation of the enterprises' profits.

2.1.5.2 Elective Approach

The main feature of the *elective approach* is the freedom to self-categorize. Indeed, entities have the right to determine whether they fall into the characteristics of a transparent or non-transparent entity in the State applying this approach. This approach is applied by a few States only. One of the States using this system is the US, where it is referred to as the *check the box* system.[68] The US' check-the-box system applies to both domestic and foreign entities for tax purposes. In this approach, there are in essence two options. The entity can be classified as a corporation, a partnership, or as a disregarded entity. The corporation is regarded as a non-transparent entity. Partnerships and disregarded entities are considered to be transparent. There is a partnership in place if there are two or more participants. An entity is disregarded if there is only one

[64] Decree of 30 March 2001, no. RTB2001/1379M, recently replaced by DGB 2014/3099.
[65] Bolhaar, W.H.H. (2013). *Naar een systeem ter voorkoming van hybride mismatches*. NTFR Artikelen 2013/25.
[66] Avery Jones e.a., (2002). *The characterization of other States' partnerships for income tax.* British Tax Review, p. 289.
[67] OECD (2009). *Partnership Report 2009*, p. 9.
[68] Regs. Sec. 301.7701-3 of the Code of Federal Regulations.

participant. It is evident that this approach is a breeding ground for hybrid entity mismatches. After all, it is easy to create a hybrid entity, as the entity can deliberately choose the opposite treatment of the other State involved.

2.1.5.3 Fixed Approach

Under the *fixed approach*, all foreign entities are classified in the same way, regardless of their characteristics. Either they are classified as transparent entities, or as non-transparent entities. Italy is one of the States that applies this approach. In this way, harmonization of classification criteria of foreign entities can be observed. Yet, by applying this method, the problem of hybrid mismatches is not prevented if the other State considers the entity as being transparent.

2.1.5.4 Symmetrical Approach

The classification of an entity is linked to the classification of the State where the entity is located when a State applies the *symmetrical approach*. The advantage of this approach lies in the fact that in both States, the location of the entity is taken as the starting point for the classification of this entity. This prevents a mismatch with regard to entities. However, there are only a few States applying this system. A reason could be that States attach value to their autonomy in terms of taxation.

2.1.6 The Netherlands Tax Treatment of non-Transparent Domestic or Foreign Entities

From a Dutch point of view, both domestic and foreign entities can be subject to CIT. In this context, a distinction can be made between resident taxpayers and foreign taxpayers. Resident taxpayers are subject to CIT for their worldwide income, while foreign taxpayers are only subject to CIT insofar there is a sufficient economic allegiance (*nexus*) with the Netherlands.[69] The nature of the tax liability, resident or foreign, depends, in first instance, on where the entity in question is established. Article 4 of the GTA states that all facts and circumstances should be considered when determining the place of residence of an entity. As a general rule, when an entity is effectively managed from the Netherlands, it is considered to be situated in the Netherlands and, therefore, resident of the Netherlands.[70] However, entities established under Dutch civil law are deemed resident in the Netherlands.[71] Hence, this is a deviation from Article 4 GTA; an entity incorporated under Dutch civil law, which has its place of effective place of management (POEM) outside the Netherlands, would be situated outside the Netherlands according to the circumstances, but it will not alter its domestic taxpayer status. Therefore, as a domestic taxpayer, it will be, in principle, taxable for its worldwide income in the Netherlands. Under these terms, one can notice that residency in the Netherlands

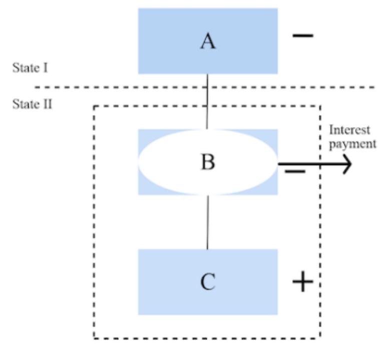
[69] Article 3, par. 1 of the CITA 1969.
[70] See, for example Supreme Court 1 July 1987, No, 23.877, BNB 1978/306, and Supreme Court 27 April 1988, No. 24.252, BNB 1988/181.
[71] Article 2, par. 4 of the CITA 1969.

based on factual circumstances with particular regard to the POEM is, de facto, only relevant for foreign entities.

2.1.7 Hybrid Entity Mismatch in the Netherlands

2.1.7.1 Double Deduction

Suppose again that entity A, B and C are associated enterprises. Hybrid entity B is non-transparent in State II, but considered to be transparent from the perspective of State I. entity B pays interest to a third party.



As State II considers hybrid entity B as being non-transparent, it allocates the interest payment to entity B. The interest payment made by entity B is set-off against the income of C under a group tax regime in State II.

State I, however, allocates the interest payment to entity A, as it considers hybrid entity B as transparent. The interest payment is now deducted by A as well as by B (and set-off against the income of C).

The Netherlands as State I

From a Dutch point of view, foreign entity B is considered to be transparent. Hence, the interest payment is considered to be made at the level of participant A. The interest payment will now be deducted from the profit of entity A, regardless of the treatment of the interest payment in State II. The Netherlands does not provide any special provision to prohibit this DD outcome as situated above.

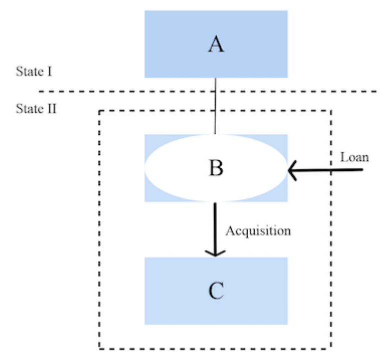
The Netherlands as State II

From a Dutch point of view, entity B is considered to be non-transparent. Hence, the interest payment is considered to be made at the level of this entity. The interest payment will now be deducted from the profits of entity B, and subsequently set-off against the income of entity C. Again, the Netherlands does not provide any special provision to prohibit this DD outcome, unless the loan is considered to be a loan to finance the acquisition of entity C (participation loan).[72]

[72] Article 13l, par. 6(a) of the CITA 1969.

The deduction of interest on participation loans, as entered into force from 1 January 2013, is limited under the Dutch CITA,[73] since the Netherlands desires to limit excessive or undesirable financing of participations.[74] This is a general anti-abuse provision, and as such does not fall within the scope of this thesis. However, the author considers it relevant to discuss one specific component of this anti-abuse measure. This concerns the measure that provides limitation of interest deduction for situations in which a taxpayer is classified as being transparent in the parent jurisdiction, which makes it possible that interest on participation loans can be deducted in both the parent State as well as in the Netherlands (DD outcome).[75] It concerns the following situation.

In this figure, entity B is non-transparent from the perspective of State II (the Netherlands), but is considered to be transparent from the view of State I. Hence, as shown in previous examples, a DD outcome is in place.



Insofar the loan is acquired by entity B to finance the acquisition or extension of its participation in entity C, and the interest on this same loan is furthermore deductible on the level of any other associated entity (in case entity A), then the interest deduction might be limited or denied.

Under the same general anti-abuse provision, another provision has been introduced that limits or denies interest deduction insofar a hybrid financial instrument is in place. This provision is outlined under section 2.3.5.1.

Another comparable provision is in place under the Dutch CITA. As it will be discussed in more detail under section 2.3.2, the Netherlands has a *classical approach* regarding the treatment of equity and debt for corporate tax purposes. This means that, as a rule, interest on debt is deductible at the level of the payer for CIT purposes, while being fully taxable at the level of the recipient. Nonetheless, remuneration on equity will fall outside the taxable base. This situation could lead to tax base erosion when companies opt to increase their interest expenses in the Netherlands, while, at the same time, this interest income is received by an associated entity in a foreign jurisdiction with a low CIT rate, or no CIT rate at all. In order to prevent

[73] Article 13l of the CITA 1969.
[74] The CJEU ruled under the *Bosal* case that the Netherlands cannot restrict the deduction of (interest) costs relating to participations not having their place of residence in the Netherlands, while allowing Dutch parent companies a deduction of (interest) costs relating to a participation if this subsidiary is resident in the Netherlands, or derives profits taxable in the Netherlands. The introduction of Article 13l of the CITA 1969 can be considered as a response to this judgement. See C-168/01, *Bosal Holding vs Staatssecretaris van Financiën*. See in this respect also the Documents of the Second Chamber of Parliament 2010/11, 32 800, no. 17.
[75] Article 13l, par. 6(a) of the CITA 1969.

these kinds of arrangements, the legislator created an anti-abuse measure, providing that interest deductions shall be denied in several tax base eroding situations. Based on Article 10a, paragraph 1 of the CITA, the deduction of interest – currency results and other costs included – paid or accrued on debt instruments attracted by the taxpayer, directly or indirectly – legally or de facto – from a related party, is denied if the loan is attracted, directly or indirectly – legally or de facto – in connection with certain categories of *tainted transactions*. The fact that an entity enters into this debt instrument after the tainted transaction takes place does not necessarily prevent it from being connected to the tainted transaction. Article 10a, paragraph 1 of the CITA lists the following categories of tainted transactions:

1. A distribution of profit or return of capital by the taxpayer (or certain related entities) to a related party;
2. A capital contribution by the taxpayer (or certain related entities) to a related entity; and
3. An acquisition by the taxpayer (or certain related entities), or expansion of an interest of shares, in a company that is a related entity after this acquisition or the expansion of an existing interest in such entity.

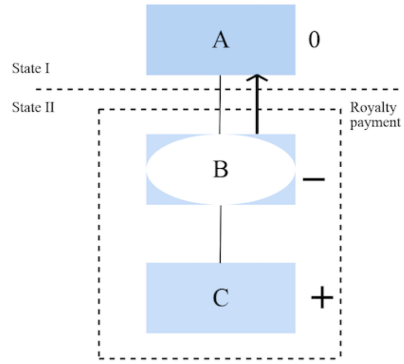
The interest paid or accrued on the debt attracted or created by the taxpayer in connection with a tainted transaction is nevertheless deductible if the taxpayer had valid business reasons both for entering into the transaction and for funding the transactions with debt.[76]

This test will not be met if there is a so-called *non-business* diversion. The Dutch State Secretary explained in his decision that a non-business diversion is in any case in place when the taxpayer creates a mismatch by making use of the difference in the fiscal qualification of the legal form of a financial instrument.[77] Thus, HMAs have been brought under the anti-abuse provision by the decision of the State Secretary. If profit drainage, as referred to in Article 10a CITA, is involved, using hybrid structures, an interest deduction restriction applies.

[76] Article 10a, par. 3 of the CITA 1969.
[77] Decree of 3 April 2013, no. BLKB2013/110M, par. 4.2.2, p. 4.

2.1.7.2 Deduction/Non-Inclusion

Suppose again that entities A, B and C are associated enterprises. Hybrid entity B is non-transparent in State II, while it is considered to be transparent from the view of State I. A royalty payment is made from entity B to entity A.



As State II considers hybrid entity B as non-transparent, it allocates the royalty payment to entity B. The payment by entity B is set-off against the income of entity C under a group tax regime in State II.

State I, however, does not include the royalty income in the tax base of entity A, as it does not recognize the royalty payment made by entity B to entity A. Indeed, State I considers entity B as transparent, and thus allocates the royalty payment to entity A. However, since entity A is the recipient of this except same payment, no transaction is recognized. The royalty payment is now deducted by entity B and set-off against the income of entity C, but non-included by entity A.

The Netherlands as State I

From a Dutch perspective, foreign entity B is considered to be transparent. Hence, the royalty payment is considered to be made at the level of participant A. The Netherlands does not include the royalty income in the tax base of entity A, as it does not recognize the royalty payment made by entity B to entity A. The treatment of the royalty payment in State II is not considered by the Netherlands, and the Netherlands does not provide for any special provision to prohibit a D/NI outcome as described above.

The Netherlands as State II

According to Dutch rules, entity B will be considered to be non-transparent. Hence, the royalty payment will be considered to have been made at the level of this entity. In this manner, the royalty payment will be deducted from the profits of entity B, and, subsequently, set-off against the income of entity C. The Netherlands does not provide for any special provision to prohibit a D/NI outcome as previously illustrated.

2.2 Reverse Hybrid Entity Mismatch

In the foregoing examples under section 2.1, the HMA was characterized by a payment made *by* the identified hybrid entity itself. However, the cause of an HMA can also be found in the payment made *to* the hybrid entity. When such a situation occurs, a *reverse hybrid entity* might be in place. As well as it is the case for *regular* hybrid entity structures, a reverse hybrid entity mismatch results in a D/NI outcome, due to a difference in classification of that reverse hybrid entity. In case of a reverse hybrid entity mismatch, however, the state where the participants reside, considers the entity to be non-transparent, while the opponent state (*i.e.* the state where the entity resides), considers the entity to be transparent. Hence, the latter state does not tax any profits, as it allocates profits made to the participant(s), being a resident in another state. That other state, on its turn, considers the same entity to be non-transparent, and thus, it does not recognize any taxable income within its tax jurisdiction. The consequence is now that a payment to a reverse hybrid entity may be deductible, while, on the other hand, the corresponding income is not included in any tax base. Indeed, none of the states involved recognize any justification to levy tax on the object of income.

In terms of nature and scope, the reverse hybrid entity mismatch corresponds to the previously discussed hybrid entity mismatch to the utmost extent. Hence, the description of the reverse hybrid entity mismatch will build upon the output under section 2.1. The example under the following section clarifies the functioning of HMAs with reverse hybrid entities.

2.2.1 Deduction/Non-Inclusion[78]

Infer that entities A, B and C are associated enterprises. Hybrid entity B is now transparent in State II, but non-transparent in State I (reverse hybrid entity). An interest payment is now made from entity C to entity B. Perceptibly, this interest payment is deductible at the level of entity C. However, as State II considers entity B as being transparent, it does not recognize the interest income at the level of entity B, and consequently does not recognize any taxable object. Instead, it allocates the interest income to entity A, over which it has no tax jurisdiction. In contrast, State I does not include the interest income in the tax base of entity A, as it does not recognize any interest income as well. In fact, being that State I considers entity B as non-transparent, the interest is considered to be received at the level of entity B, situated in State II. The interest payment is now deducted at the level of entity C, without any corresponding income inclusion at the level of entity B nor entity A. Consider the following section for the corresponding illustration.

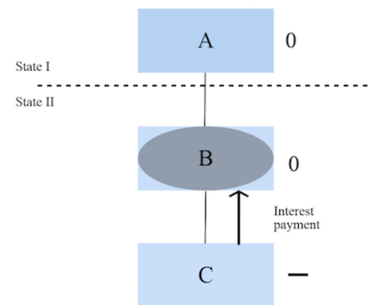
[78] EC (2016). *Proposal for a Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164, p. 8.

2.2.2 Reverse Hybrid Entity Mismatch in the Netherlands

2.2.2.1 Deduction/Non-Inclusion

For the sake of consistency, the example provided under the aforementioned section will be briefly repeated.

Presume again that entity A, B and C are associated enterprises. Hybrid entity B is transparent in State II, but non-transparent for State I. Entity C pays interest to entity B.



Entity C deducts the interest payment from its tax base in State II. Nevertheless, as State II considers entity B as transparent, it allocates the interest income as being received by entity A situated in State I.

State I, on the other hand, does not include the interest income in the tax base of entity A, as it considers entity B as non-transparent. State I allocates the entitlement of the interest income to entity B, over which it has no tax jurisdiction. The interest payment is now deducted by entity C, but non-included by entity B nor by entity A.

The Netherlands as State I

Under this hypothesis, following to Dutch provisions, foreign entity B would be classified as a non-transparent entity. Hence, the interest income would be considered to be received at the level of entity B. The Netherlands would only include the interest income in the tax base of entity A, when entity B will subsequently distribute the profits to entity A. Depending on facts and circumstances, entity A may, in that case, opt for the Netherlands' participation exemption.[79] The Netherlands does not provide for any special provision to prohibit a D/NI outcome as described above.

The Netherlands as State II

From a Dutch point of view, entity B is considered to be transparent. Hence, the interest payment is considered to be made from entity C to entity A. The Netherlands allows a deduction of interest at the level of entity C. Simultaneously, the Netherlands does not tax the income received at the level of entity B since it considers this entity as being transparent, nor does it tax the income at the level of entity A, as this entity

[79] Article 13 of the CITA 1969.

does not fall within the scope of the Netherlands tax jurisdiction. The Netherlands does not provide any special provision to prohibit a D/NI outcome as mentioned above.

2.3 Hybrid Financial Instrument Mismatch

Equity and debt are likewise utilized to raise capital in order to fund the entity's assets. From a mere functional and economic perspective, equity and debt are equivalent.[80] Nonetheless, both financial instruments differ with regard to their characteristics and features. There are certain circumstances in which making use of debt can be more beneficial for the entity than opting for equity, especially for reasons of taxation. An important distinction is that the interest payments made to the debt holders are normally viewed as a deductible expense for the paying entity, whereas dividends on equity financing are considered to be the pay-outs of profits and therefore not regarded as tax-deductible expenses. Correspondingly, dividend received is not considered as income of the entity, and conversely, the interest-receiving entity is in general fully taxed for the interest payment received.

The difference between debt and equity seem to be evident. However, it is found on little theoretical basis.[81] The distinction is unclear, and instead, the divergence is blurred, meaning that, in practice, it is often challenging to determine the difference between equity and debt. Definitely, this is the case inasmuch as we can encounter a large variety of financial instruments, with particular features turning its nature more and more complex. The distinction between debt and equity can become so unclear that a grey area emerges. The financial instruments applied to financing corporations in this grey area are known as hybrid financial instruments, which could lead to a hybrid mismatch.

2.3.1 Deduction/Non-Inclusion[82]

On this occasion, entity A and entity B are associated enterprises. Entity B is funded by entity A with an instrument that, due to its hybrid character, qualifies as equity in State I, but it is considered to be debt from the perspective of State II. When payments are made under the instrument, they are deductible interest expenses for entity B. However, the corresponding receipts are treated as exempt dividend payments for tax purposes in State I. As a result, a net deduction arises in State II, without a corresponding income inclusion in State I.

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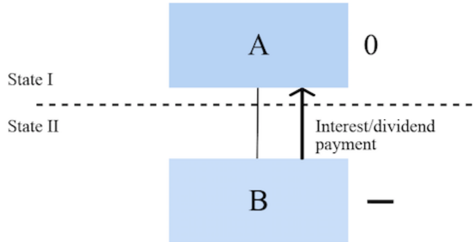
[80] Flannigan, R. (2011). *The Debt-Equity Distinction*. Banking and Finance Law Review, Vol. 26, p. 461.
[81] Emmerich, A. O. (1985). *Hybrid instruments and the debt-equity distinction in corporate taxation*. The University of Chicago Law Review, p. 118.
[82] OECD (2012). *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, p. 9.



2.3.2 The Tax Treatment of Debt and Equity in the Netherlands

The Netherlands has a *classical approach* for the treatment of equity and debt for CIT purposes. This means that, as a rule, interest on debt is deductible at the level of the payer for CIT purposes, and fully taxable at the level of the recipient.[83] However, from a tax point of view, there are some limitations to this rule. Firstly, the interest paid on a loan that qualifies as equity for tax purposes is not deductible. Furthermore, interest expenses are only deductible insofar they are at arm's length, and no deduction takes place with respect to the (value of the) conversion rights in case a loan is convertible into shares.

In contrast, income from equity, *i.e.* dividends and capital gains, can benefit from a full exemption from CIT pursuant to the participation exemption,[84] provided that the relevant requirements are met. These requirements state that the subsidiary needs to have a capital divided into shares, in which the parent company holds an interest of at least 5 percent of the nominal payed-up share capital of the subsidiary.[85] Furthermore, in order to be in the position to apply for the participation exemption, it is required that the parent company does not hold its interest in the subsidiary as a portfolio investment,[86] and the subsidiary should be subject to CIT resulting in a realistic level of taxation for Dutch tax purposes.[87] Normally, an effective tax rate of 10 percent or more will be considered to meet this requirement.[88] Finally, the assets of the subsidiary should not consist, either directly or indirectly, out of 50 percent or more of low-taxed free portfolio investments.[89] At the level of the payer, the payments made pursuant to instruments qualifying as equity for tax purposes are not deductible.

[83] Economists have for long diagnosed a "debt bias", which would infringe the concepts of equal treatment under tax law. For the purpose of this thesis, the author renounce from this discussion. See in this respect, however, Schön, W. (2012). *The Distinct Equity of the Debt-Equity Distinction*, 66 Bull. Intl. Taxn. 9, Journals IBFD.
[84] Article 13 of the CITA 1969.
[85] *Ibid*. par. 2.
[86] *Ibid*. par. 9.
[87] *Ibid*. par 11(a).
[88] Documents of the Second Chamber of Parliament, 2009-2010, 32 129, no. 3, p. 61-62.
[89] Article 13, par. 11(b) of the CITA 1969.

Accordingly, a fundamental question for Dutch CIT purposes is whether an instrument qualifies as equity or debt. The Unilever-case[90] provides for more clarity on the qualification of financial instruments as either equity or debt. From this judgment, it can be derived that the legal form of an instrument is determinative, except when any one of the following three situations occurs:[91]

1. parties had the intention to provide equity, although the legal form appears otherwise (*schijnhandeling*, sham operation);
2. the terms and conditions of the instrument are such that the investor participates to a certain degree in the business of the issuer (*deelnemerschapslening*, participating loan); or
3. the investor holds shares in the issuer that qualify as a participation for the purposes of the participation exemption, and provides additional debt financing to the issuer under such circumstances that the investor must have been aware from the outset that the financing either would not be repaid or would not be repaid in full (*bodemloze put*, loss financing).

A participating loan is codified under the CITA and under this provision, deduction of interest paid on a loan is not allowed if the loan is granted under such circumstances that it functions as equity of the borrower.[92] In later case law, the participating loan has been further explained by the Dutch Supreme Court. A debt instrument is treated as equity for CIT purposes if the following requirements are cumulatively met:

a. the return is (almost) entirely dependent on the profits of the borrower;[93] and
b. the loan has no final maturity or has a final maturity of more than 50 years;[94] and
c. the loan is subordinated to all creditors of the borrower.

Although the legal form of a financial instrument is determinative, the upper situations show an independent equity qualification for CIT purposes, which is referred by the *substance over form* doctrine. Surprisingly, the Dutch Supreme Court has a different approach on the requalification of equity as debt. In 2011, the Dutch Court requalified a participation expressed in Australian redeemable preference shares (RPS) with a fixed term, and without voting rights, hold by a Dutch investor as a debt instrument.[95] As a result, the income derived from the RPS was fully taxable rather than exempt pursuant to the exemption. As the taxpayer appealed, the Dutch Supreme Court decided differently. If according to civil standards, a financial instrument is considered to be equity, then this must also be assumed for the application of CIT.[96]

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[90] Supreme Court, 27 January 1988, BNB 1988/217.
[91] *Ibid*. par. 4.4.
[92] Article 10, par. 1, under d of the CITA 1969.
[93] Supreme Court, 25 November 2005, BNB 2006/82.
[94] Supreme Court, 8 September 2006, BNB 2007/104.
[95] Court Haarlem, 25 January 2011, no. 09/3391, V-N 2011/32.12.
[96] Supreme Court 7 February 2014, no. 12/03540, BNB 2014/79.

In a second assessment, the Dutch Supreme Court came to the same conclusion. In the Bank Syndicate case, a granted loan was refinanced in such a way that, eventually, the financial instrument changed from debt to equity, resulting in the application of the participation exemption.[97] The tax authorities argued that for CIT purposes, requalification from equity to debt should take place. Again, the Dutch Supreme Court ruled that if according to civil standards, a financial instrument is considered to be equity, reclassification for CIT purposes cannot be applied. Both cases provide clarity and therefore legal certainty.

2.3.3 Defining a Hybrid Financial Instrument

As previously discussed, a hybrid financial instrument can be considered as a financial instrument operating in an area where the distinction between debt and equity is indistinct. Yet, a generally accepted definition of hybrid financial instruments does not exist.[98] Hybrid financial instruments can be considered to be *bundled rights and obligations, which have legally combined value determining characteristics underlying more than one basic form of financial instrument*.[99] Hybrid financial instrument mismatches can be considered as financing tools, which combine characteristics of both equity and debt (such as redeemable preference shares or profit-participating loans).[100]

A hybrid financial instrument can also be defined from an EU law perspective. On the first of January 2016, the amendment of the Parent-Subsidiary Directive (PSD) came into force.[101] This amendment was proposed to solve the issue of double non-taxation within the EU, caused by different tax qualifications given by the Member States to a hybrid financial instrument.[102] By reading the explanatory memorandum of the proposal of the amended Directive, one could define a hybrid financial instrument as a funding arrangement, having characteristics of both debt and equity, resulting in differential treatment, arising in the application of the tax rules of two different jurisdictions. The jurisdiction in which the payer is established considers the financial instrument as debt, while the jurisdiction in which the recipient is situated, considers that same financial instrument as equity.

The OECD applies a similar approach as the EU when defining a hybrid financial instrument. The OECD recognizes a hybrid financial instrument at the moment when a payment results in a hybrid mismatch, where

[97] Supreme Court 7 February 2014, no. 12/04640 BNB 2014/80.
[98] Bärsch S.E. (2012). *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context: Issues and Options for Reform*. Springer Science & Business Media, p. 10.
[99] Ibid.
[100] Sasso, L. (2013). *Capital structure and corporate governance: the role of hybrid financial instruments*. Doctoral dissertation, The London School of Economics and Political Science, p. 47.
[101] EC (2014). *Council Directive (EU) 2015/121 of January 2015 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.*
[102] See the explanatory memorandum EC (2013). *Proposal for a Council Directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries in the different Member States*, COM(2013) 814 final (25 Nov. 2013).

the mismatch can be attributed to the terms of a financial instrument.[103] However, in the light of this thesis, the definition mentioned in the ATAD might be considered as the most relevant one, which reads as follows: "*a situation involving (...) an entity, where a payment under a financial instrument gives rise to a D/NI outcome, and such payment is not included within a reasonable period of time, and the mismatch outcome is attributable to differences in the characterization of the instrument of the payment made under it.*"[104]

2.3.4 Hybrid Financial Instruments under the Netherlands Tax Law

It is noteworthy that the Netherlands did not specifically provide a definition of the term hybrid financial instrument in its national law. However, as from the introduction of the Consultation Document on the implementation of the ATAD on 29 October 2018, a definition of the term hybrid financial instrument is provided for in the explanatory memorandum:[105]

"*A financial instrument is any instrument that accesses yields on equity or debt.*[106] *A financial instrument is considered to be a hybrid financial instrument when the payer State allows deduction while the payee State does not include this payment in the taxable profits of the payee, where this is the result of qualification differences of the instrument or the payment.*"

Moreover, by implementing the aforementioned amendments of the PSD,[107] Article 13, paragraph 17, and Article 13aa, paragraph 7 of the CITA have been introduced. The provision states that the participation exemption, which normally ensures the tax exemption of dividend distribution within groups,[108] does not apply to benefits from a participation to the extent that these benefits consist of distributions made by the entity in which the participation is held insofar these payments are directly or indirectly deductible for any CIT under any jurisdiction. The legal text of the provisions implemented in the Dutch CITA is broadly formulated, and, strictly interpreting that provision from its wording, the participation exemption does also not apply to hidden distributions of dividends as a result of *e.g.* an adjustment of the at-arm's-length based interest, which has led to a deduction at the level of a subsidiary abroad.[109] However, the memorandum explicitly states that the provision relates to mismatches that are the result of the nature of the instrument,

[103] OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements*, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 14, p. 18.
[104] EC (2017). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164, Article 1, amended Article 2(b).
[105] Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 16.
[106] As from 2020, the term *financial instrument* will be codified under Article 12ac, par. 1(e) CITA 1969.
[107] EC (2014). *Council Directive 2014/86/EU of 8 July 2014 Amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States*.
[108] Article 13, par 1 of the CITA 1969, states that while determining the taxable profit, the benefits arising from a participation are not taken into account. In the sense of this provision, a participation is considered to be an interest of at least 5% of the nominal capital in a company See Article 13, par 2 of the CITA 1969.
[109] See for a current reflection of the Arm's Length Principle: Navarro, A. (2018). *The Arm's Length Standard and Tax Justice: Reflections on the Present and the Future of Transfer Pricing*, 10 World Tax J. (2018), Journals IBFD.

and does not include mismatches that are the consequence of a different approach of the at-arm's-length principle.[110] In this way, the legal text undeniably contradicts the parliamentary history, causing in such a manner legal uncertainty.

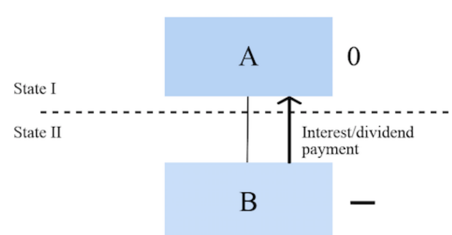
It is evident that, per 1 January 2016, the participation exemption is no longer applicable to remuneration or payments derived from a participation to the extent that remuneration or payment can be deducted legally or de facto, directly or indirectly, from a CIT basis in the jurisdiction wherein the payer of that remuneration resides. Contrarily to the PSD, the scope of the Dutch anti-abuse provisions is not limited to intra-EU situations. With this global application, the Netherlands responds to worldwide developments, such as the OECD BEPS Project.[111]

Undoubtedly, the implementation of this provision reflects the compromise of the Dutch government to combat mismatches due to hybrid financial instruments and its effort to align national rules with the amended PSD. Grateful to this achievement, we can deduct from national legislation a definition for hybrid financial instruments. When taken into account the Netherlands' tax law along with the definitions derived from literature and the provided definitions by BEPS Action 2 as well as the ATAD, one can define a hybrid financial instrument as a financial instrument under which a payment is made, which is considered to be an untaxed profit distribution from the perspective of the State of residence, while, from the perspective of the opponent State, the payment made is deductible for CIT purposes.

2.3.5 Hybrid Financial Instrument Mismatch in the Netherlands

2.3.5.1 Deduction/Non-Inclusion

A is an entity established in State I. B is an entity established in State II. Entity A and entity B are associated enterprises. Entity A issues a hybrid financial instrument to entity B. The instrument is treated as debt from the perspective of State I, whereas state II qualifies this same instrument as being equity. Therefore, the payments are deducted by entity A, while not being included in the tax base of entity B.



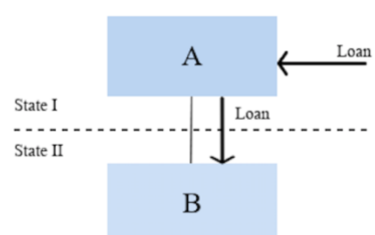
[110] Documents of the Second Chamber of Parliament, 2015, 34306, par. 3, p. 4.
[111] *Ibid.* par. 1, p. 2.

The Netherlands as State I

Considering the Netherlands as State I, an interest payment is made from entity A to entity B, whereas entity B is established in another state. The Netherlands allows a deduction of the interest at the level of entity A, regardless the treatment of the payment at the level of entity B. The Netherlands, in principle, does not provide for any special provision to prohibit a D/NI outcome yet, as demonstrated above. The Netherlands should adjust the CITA in order to be in line with the ATAD provisions, as it will be addressed at a later stage in this thesis. This will be particularly of relevance in relation to third States since such a mismatch is already obviated in intra-EU situations.[112]

An anti-abuse provision is however in place when the loan granted from entity A to entity B is considered to be a participation in the meaning of Article 13l of the CITA 1969. As discussed under section 2.3.2, a participation loan is considered to be an equity instrument for tax purposes, despite its legal form. Elaborating on section 2.1.7.1, the deduction of interest on participation loans is limited under the Dutch CITA since the Netherlands desires to limit excessive or undesirable financing of participations. This is a general anti-abuse provision, and as such does not fall within the scope of this thesis. However, this provision includes a measure that provides limitation of interest deduction for situations in which a hybrid financial instrument is in place that facilitates deduction in both the Netherlands as well as in the State where the subsidiary is situated.[113] It concerns the following situation.

In this figure, entity A enters into a loan with a third party in order to finance the acquisition of extension of its participation in entity B. Both entity A and entity B may deduct their interest expenses. Yet, as from a Dutch point of view, the loan from entity A to entity B is considered as a participation loan (compare **section 2.3.2**), it qualifies as an equity instrument and the payments received arising from the participation loan fall within the scope of the participation exemption.



The Netherlands as State II

From a Dutch point of view, a dividend distribution is made from entity A to entity B, whereas entity A is situated in another State. Depending on facts and circumstances, entity A can opt for the participation exemption, keeping the dividend distribution outside the scope of the taxable base.[114] As from 2016,

[112] EC (2014). *Council Directive 2014/86/EU of 8 July 2014 Amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States*.
[113] Article 13l, par. 6(b) of the CITA 1969.
[114] Article 13, par 1 of the CITA 1969.

however, a new provision has been introduced regarding the participation exemption. As discussed, the provision states that the participation exemption – which normally ensures the exemption of dividend distribution within groups – does not apply to benefits from a participation to the extent that these benefits consist of distributions made by the entity in which the participation is held insofar these payments are directly or indirectly deductible for any CIT.[115] In the previous case, it is given that the hybrid instrument is considered to be an interest payment from the perspective of State I. Hence, according to the *classical approach*, the payment made is deductible for tax purposes at the level of entity A. Therefore, the Netherlands refuses the application of the participation exemption, which means that the payment made is included in the tax base of B. An HMA is avoided.

2.4 Permanent Establishment Mismatch

In the foregoing paragraphs, it was assumed that MNEs conduct their cross-border activities via a subsidiary in the other State(s) concerned, characterized by the presence of associated enterprises. Instead, MNEs may also opt for a so-called branch in this other State. Whereas a subsidiary is a separate legal entity, a branch is considered to be an extension of the investor entity. Thus, it is regarded to be a *dependent* part of the entity itself, similar to a business section or department.

A profit can only be achieved by the total entity because only the entity in its entirety bears rights and responsibilities.[116] As the branch participates in achieving this income, the States empowered to raise taxes do have self-interest to seize that portion of income for taxation that has been procured within their sovereign territory. However, not every cross-border business activity justifies the assignment of tax jurisdiction. The business activity concerned must have at least an allegiance with the State involved to justify taxation in that State. When an MNE carries out cross-border activities throughout a branch, this only leads to tax liability in this foreign jurisdiction when this branch can be regarded as a so-called permanent establishment (PE).[117] In line with international tax allocation principles, a PE in a State is considered to justify the allocation of tax jurisdiction to the State involved.[118]

PE mismatches have not been covered in the initial questionnaire of the EUCOTAX 2018, Subtopic 4. However, similarly to the previously discussed HMAs, PE mismatches are the product of inconsistencies in domestic rules as well, as they intend to exploit differences in the domestic rules for determining whether

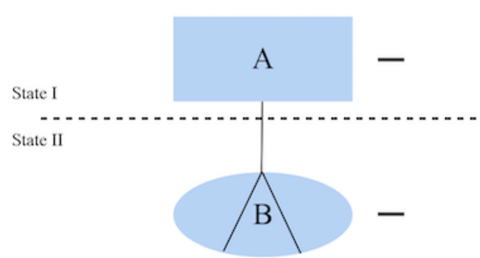
[115] Article 13, par 17 of the CITA 1969.
[116] Becker, H. (1989). *The determination of income of a permanent establishment or branch*. 17 Intertax, Issue 1, p. 12.
[117] Roumen, R.H.M. (2017). *Algemene leerstukken Vaste Inrichting*. NDFR, par. 1.
[118] In particular, the principle or origin justifies tax jurisdiction to the PE State. Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 7.2.2.2, p. 355 – 362.

an enterprise is subject to tax in a particular jurisdiction. Likewise, a PE mismatch can be used to produce DD outcomes or D/NI outcomes in the same way as the types of mismatches that are targeted by the recommendations in Action 2 of the BEPS Report. Hence, in order to provide the lector with a clear panorama of all HMAs, the author will briefly examine the concept of PE mismatches.

For a better insight of when PE mismatches occur, consider the following situation. A taxpayer carries out business activities in another State through the presence of a branch in that latter State. Assume that the branch State does not recognize sufficient economic allegiance with that branch and, therefore, in the absence of a PE (*i.e.* in the absence of justification grounds), that State will not exercise its tax jurisdiction. Meanwhile, based on its national legislation, the State of residence *does* consider the business activities as being carried out by a PE in that other State. It is common that the State of residence provides for a so-called *object exemption* when that State assumes the presence of a PE in the other State. All profits related to that PE are now exempt in the State of residence. Consequently, neither the State of residence nor the branch State levies taxation on the business activities carried out by the branch. This is just an example of a mismatch involving a PE. The following sections will illustrate two other cases of PE mismatches.

2.4.1 Double Deduction[119]

In this case, branch B is recognized as a PE in State II, whereas it is not recognized as such by State I. Under these terms, a payment, expense or loss is deductible from the taxable base both in the jurisdiction in which the taxpayer is a resident as well as in the jurisdiction of the PE. In contrast to the aforementioned, both States involved can claim taxing rights on income generated by entity A, either as entity A being a stand-alone entity, or on the basis of the presence of a PE. Consequently, the tax base of entity A can be eroded twice as shown in the following illustration.

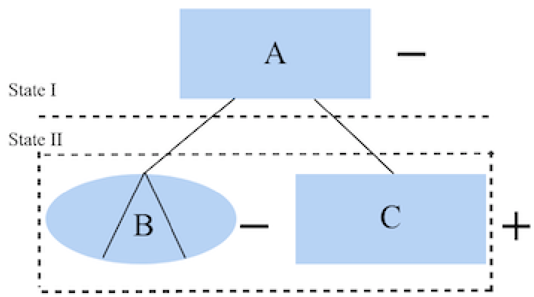


Nonetheless, this does not necessarily result in an HMA. A payment, expense or loss might be deductible in both State I and State II. Yet, this can only erode the tax base when this deduction can be offset against

[119] EC (2016). *Proposal for a Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164, p. 10.

taxable profits which are not included in the two tax jurisdictions. In the upper case, though, it is insurmountable that taxable profits will be recognized twice as well, which consequently eliminates the occurrence of an HMA.

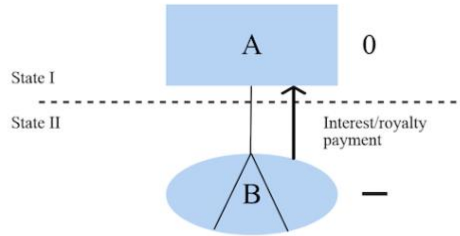
Now consider the situation in which entity A establishes both a branch operation and a subsidiary in State II. Assume that State II permits the subsidiary (entity C) to form a tax group with branch B, as it is considered to be a PE in that State. In such a case, the branch is allowed to offset its expenditures incurred to the income of entity C (*i.e.* against non-dual inclusion income). If the branch is treated as taxable under the laws of State I as well, then the expenses incurred by that branch will give rise to a separate deduction under the laws of both State I and State II. This structure, therefore, allows the same expenditures to be set off simultaneously against different items of income in the residence and branch jurisdiction.



2.4.2 Deduction/Non-Inclusion[120]

In this section, a situation similar to the one shown in section 2.4.1 will be observed, whereas branch B is again recognized as a PE in State II by that State, while this is not recognized as such by State I. Suppose now that a payment is made from the PE to the head office. This payment is now deductible from the taxable base in the jurisdiction in which the PE is situated. However, it is not included in the taxable base in the jurisdiction in which the taxpayer is a resident, because the latter jurisdiction does not recognize the PE, and hence does not recognize the payment as well. A payment is deducted for tax purposes in State II, while the subsequent receivables are not recognized in State I.

[120] *Ibid.*



2.4.3 A Permanent Establishment in the Netherlands

The Netherlands has no general definition of the concept of a PE. Although an explanation of the term PE is included in the CITA,[121] this explanation only applies to a specific provision concerning the exemption of foreign-company profits in situations wherein no double tax convention is present.[122] Nevertheless, the explanation of the CITA is considered to be a guiding concept of a PE in the Netherlands,[123] and describes a PE in accordance with the OECD definition, where a PE is defined as *a fixed place of business through which the business of an enterprise is wholly or partly carried on.*[124] So, for the explanation and method of application of the PE concept in the Netherlands, one can rely on the OECD Model Convention and its commentary.[125] The concept of PE used in the Netherlands can thus be affected by OECD developments. The OECD Commentary remarks that to fulfill the PE concept, it has to contain the following conditions:[126]

- There has to be a *place of business* taking examples such as premises or, in certain circumstances machinery or equipment;
- The place of business must be *fixed*, meaning it must be established in a distinct place with a certain degree of performance;
- The business of the enterprise must be carried out through this fixed place of business. Meaning that there should be people who, in one way or another, are dependent on the enterprise (personnel) that conducts the business of the enterprise.

The assessment of whether a PE is in place, depends on the interpretation of the PE concept of the State involved. Again, a PE mismatch might occur when the jurisdiction of residency versus the branch jurisdiction (*i.e.* the jurisdictions in which respectively the head office and the branch are located) take a different view regarding the allocation of income and expenditure between the branch and head office. This

[121] Article 15f of the CITA 1969.
[122] Article 15e, par. 2(b) of the CITA 1969.
[123] Bouwman, J.N., & Boer, M.J. (2016). *Wegwijs in de Vennootschapsbelasting*. (15th ed.). Deventer, The Netherlands: Wolters Kluwer, par. 11.2.2.2.
[124] Article 5, par. 1 of the OECD MC.
[125] Documents of the Second Chamber of Parliament, 2011–2012, 33 003, no. 3, p. 97.
[126] OECD. *Commentaries on the Articles of the Model Tax Convention*. Commentary on Article 5 Concerning the Definition of Permanent Establishment, par. 2.

includes situations where the branch jurisdiction does not treat the entity as having a presence in that jurisdiction that could justify the taxation of business activities.[127]

It goes beyond the purpose of this thesis to elaborate the PE concept in more depth. What is important to note, however, is that the Netherlands grants an object exemption when it assumes that the branch in the other State is considered to be a PE.[128] All profits related to that PE are now exempt in the Netherlands, regardless of the treatment of this branch in the other State.

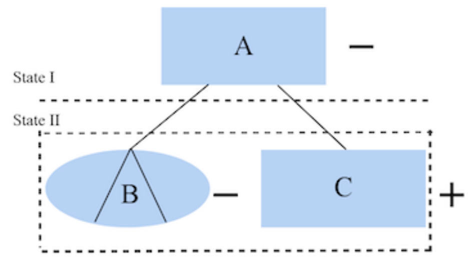
[127] OECD (2016). *BEPS Action 2 Branch Mismatch Structures, Publish Discussion Draft*, p. 4.
[128] Article 15e of the CITA 1969.

2.4.4 Permanent Establishment Mismatches in the Netherlands

2.4.4.1 Double Deduction

For the sake of consistency, the example provided under section 2.4.1 will be briefly repeated.

Branch B is recognized as a PE in State II by that same State. On the contrary, State I does not recognize this PE in State II. The PE in State II set off its expenditures against the profits of the subsidiary, as they are both parts of the same tax group. Hence, the same expenditures are deducted twice.



The Netherlands as State I

From a Dutch point of view, all costs incurred, expenses made, or losses suffered related to the branch in the other State, are considered as being deductible at the level of entity A in the Netherlands, regardless of the treatment of the branch in State II. The Netherlands does not provide for any special provision to prohibit a DD outcome as situated above.

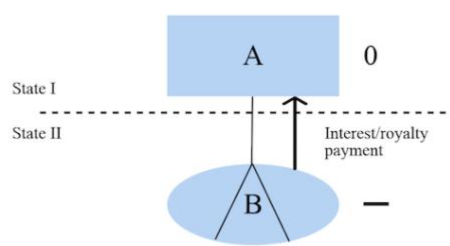
The Netherlands as State II

If the Netherlands is State II, all costs incurred, expenses made, or losses suffered related to the PE in its jurisdiction, are considered as being deductible at the level of the PE in the Netherlands, regardless of the treatment of the entity in State I. The Netherlands does not provide for any special provision to prohibit a DD outcome as situated above.

2.4.4.2 Deduction/Non-Inclusion

A reference is made to the example of section 2.4.2 in order to maintain consistency in the present work.

Branch B is recognized as a PE in State II by that same State. On the contrary, State I does not recognize this PE in State II. The PE in State II makes a payment to the head office in State I, which is considered to be deductible for tax purposes by the former State. However, as the PE is not recognized as such by State I, a taxable payment received is not reconciled by State I as well.



The Netherlands as State I

From a Dutch point of view, entity A as a whole, *i.e.* the entity including the branch in State II, is considered as being one single entity without having any allegiance in State II. Therefore, in the absence of a PE from a Dutch point of view, no cross-border transactions take place between the head office and the branch. Indeed, a transaction within one single entity is only recognized when these transactions take place from or to a PE. In the absence of any inter-entity transactions, the Netherlands does not recognize any taxation grounds, regardless of the treatment of the branch in the other State. The Netherlands does not provide for any special provision to prohibit a D/NI outcome as situated above, except for one situation, which slightly differ from the case at hand.

A parent entity and its subsidiary are both resident in the same State, and are part of the same tax group. The subsidiary has activities by way of a PE in a third State, financed through a loan from the parent entity to the subsidiary. The interest payments attributable to the PE, and consequently deductible in the PE State. Note that the PE in the opposite State is recognized by both States involved. However, the interest payment is disregarded in the resident State due to the presence of a tax group. In other words, a deduction takes place at the level of the PE, while there is no corresponding inclusion in the tax base of the parent entity; an HMA with a D/NI outcome is now in place.

Nevertheless, when determining the worldwide income of the tax group (wherein all intra-group transactions are disregarded), the resident State shall provide for a credit[129] or exemption[130] of profits related to the PE. Given the fact that interest deduction took place at the level of the PE, it would be appropriate to lower the profits of the PE with the interest payment. This would result in a lower foreign profit deduction for the prevention of double taxation and would indirectly eliminate or at least limit the effects of the HMA. However, the Supreme Court of the Netherlands ruled that interest paid between members of the same tax group related to a foreign PE shall not be considered when calculating a credit or exemption for foreign profits, even though this interest payment is deductible in the other State.[131] Consequently, the structure at hand, which is known as the *Sarakreek-structure*, remained unimpaired under case law. For this reason, a countervailable provision has been introduced,[132] stating that interest costs – that are disregarded for the Dutch CITA due to the presence of a tax group – shall be considered when calculating a foreign profit credit or exemption. This provision is intended to eliminate the Sarakreek-structure. Nevertheless, even after the

[129] Article 23a OECD MC.
[130] Article 23b OECD MC.
[131] The Supreme Court was of the opinion it would be in contrast with the character of the tax group regime to consider disregarded payments fort he calcuation of the deduction fort he prevention of double taxation. See Supreme Court 4 June 1986, no. 23.614, BNB 1986/239.
[132] Article 15ac, par. 5 of the CITA 1969. With reference to Documents of the Second Chamber of Parliament, 2000-2001, 26 854, no. 8, p. 8 – 9..

introduction of this provision, one may argue that a Sarakreek-structure can still be utilized with the use of royalty payments (consider section 5.5.2.2).[133]

The Netherlands as State II

Under this hypothesis, the Netherlands will determine to have a PE in place within its jurisdiction. Whenever this PE makes a transaction to its head office situated abroad, such as an interest payment, this interest payment will be deductible from the tax base of the PE, in the same manner as it would be if it carries out transactions with third parties. Thus, the Netherlands allows for interest deduction, regardless of the treatment of the branch in the State where the entity finds its place of residence. The Netherlands does not provide for any special provision to prohibit a D/NI outcome as situated above.

2.5 Tax Residency Mismatch

The place of residence or establishment of an entity is of relevance for the assessment of whether that entity is a domestic or foreign taxpayer (compare section 2.1.3 and section 2.1.4). Normally, entities who have their place of residence in a certain State will be considered to be domestic taxpayers in that State. Consequently, these entities are generally subject to taxation in that State for their total profit (also known as their worldwide income), irrespective of where these profits are generated.

A tax residency mismatch refers to a situation in which an entity is considered to be resident for tax purposes in two States (dual residence). Consequently, a loss or payment can be deducted in two States when both States involved use the place of residence as their criteria for tax jurisdiction for CIT purposes.[134] By applying an abstract standard, wherein the place of residence is determined according to the circumstances, the possibility arises that one entity could be considered to be a resident in more than one State for tax purposes, and is, thus, taxable for its worldwide income in both States involved.

In most cases, however, dual residence for tax purposes is obviated by bilateral tax treaties. Article 4 of the OECD Model Convention (OECD MC) arranges the allocation of the power to impose taxes between two States by designating a State of residence. This allocation is of particular importance for the proper functioning of the allocation provisions of Article 6 to 22 of the OECD MC. Article 4, paragraph 4 of the OECD MC states that, for purposes of the tax treaty, an entity is deemed to be resident of the State where

[133] However, this statement is debatable since the Dutch Supreme Court has ruled that (assumed) royalty payments between a PE and its head office, under circumstances, should be included in the calculation for foreign exempt profits. See Supreme Court 8 November 1989, no. 25 089, BNB 1990/36.

[134] Domicile or a permanent or habitual residence within the territory of a State is considered to be the basic criteria for tax jurisdiction. See Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management.

its POEM is situated. The term POEM in the sense of the OECD MC is an autonomous concept within the treaty itself. Therefore, when determining the POEM, reference is not made to the national tax law of the States concerned.[135] The OECD commentary on Article 4 indicates that the term POEM must be interpreted as a material concept (in contrast to a formal criterion such as the place of registration):[136] "*...the POEM has been adopted as the preference criterion for persons other than individuals. The POEM is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the POEM. An entity may have more than one place of management, but it can have only one POEM at any one time.*"[137]

Regardless the abovementioned, there are certain situations when the States involved have not (yet) entered into a bilateral tax treaty, and even if they have already agreed on one, the POEM can be situated in a third State. If this is the case, there is room for an HMA with a DD outcome as will be demonstrated in the following section.

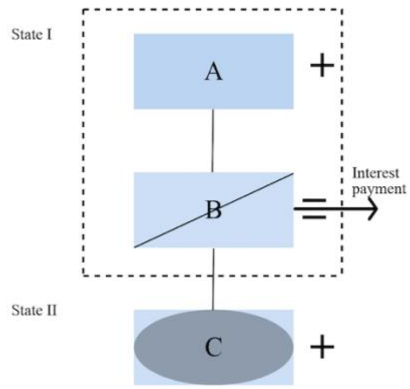
2.5.1 Double deduction[138]

Suppose that entity A, B, and C are associated enterprises. Entity B is a resident of State I as well as of State II. Entity B pays interest to a third party. As State I considers entity B as its resident and thus as a domestic taxpayer, it considers the payment made as being deductible from the tax base of entity B in that State. If one assumes that entity B does not make any profits, then the interest payment made by B would be set-off against the income of entity A under a tax group regime in State I. Likewise, as State II considers entity B as its resident (and thus as a domestic taxpayer) as well, it will include the interest payment made by entity B in the tax base of entity B in State II as well.

Moreover, entity B has established a subsidiary in State II: entity C. This subsidiary is considered to be a *reverse hybrid entity*, meaning that in the State of establishment it is considered to be a transparent entity. So, the profits made by entity C are attributed to entity D under the legislation of State II. Nonetheless, State I considers the same entity as being non-transparent, and, in this way, it does not include the profits made

[135] It is, however, possible that, due to the absence of a definition for the term POEM in the OECD MC, the meaning of this term for the purpose for the Convention is derived from the meaning of this term according to the national legislation of the Contracting States. See in this respect the OECD MC Commentary on Article 3, par. 2 with regard to undefined terms in the Convention and note 4.9 on the autonomous interpretation by Contracting States.
[136] OECD MC Commentry on Article 4, par. 22.
[137] *Ibid*. par. 24.
[138] EC (2016). *Proposal for a Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164, p. 12.

by entity C in its tax base. Consequently, entity B will be able to deduct the payment made in both State I and State II against dual non-inclusion income.



2.5.2 Tax Residency in the Netherlands

As mentioned under section 2.1.4.2 and section 2.1.6, it is Article 4, paragraph 1 of the GTA that provides for the main rule for determining the place of residence of (individuals and) entities. On the basis of this abstract standard, the place of residence of an entity must be assessed according to the circumstances. This standard is applied to each specific situation and offers freedom to the relevant parties involved to consider all relevant circumstances of the individual case.

By applying this abstract standard, a certain objectification is provided. This means that the intention of the taxpayer involved is considered to be irrelevant. The intention of a taxpayer is of relevance only if and insofar as it is expressed by its actions.[139] This also means that the assessment considers material reality and not exclusively formal indications such as the registration in a trade register like the Dutch Chamber of Commerce.

For the determination of the place of residence of an entity, the place where the actual management of that entity is located is decisive. According to the doctrine, it has been stipulated that the place where the actual management is located, is considered to be where essential decisions concerning the general management of the business are taken. Other circumstances, such as the place where the business is carried on, the place where accounts are held, the place where financial statements are being prepared, the place of residence of the management team and the place where the general meeting of shareholders takes place, are of marginal

[139] Supreme Court 2 June 2006, no. 41.553, V-N 2006/35.5, and Supreme Court 12 June 2009, no. 43.776, BNB 1993/306.

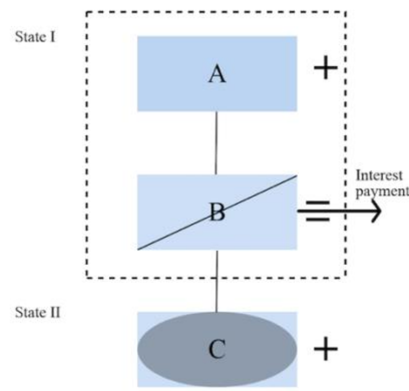
importance.[140] To determine the place where the actual management within an entity takes place, the party with final responsibility is decisive. Where the day-to-day management of the business takes place is considered to be irrelevant.[141]

Moreover, Article 2, paragraph 4 of the CITA states that entities incorporated under Dutch civil law (compare section 2.1.3) are deemed to be established in the Netherlands. Therefore, these entities are by definition and at all times subject to Dutch CIT for their worldwide income, even though when this entity is situated abroad. Consequently, to determine the place of residence of an entity incorporated under Dutch law, the provision under Article 4, paragraph 1 of the GTA has no practical impact.

2.5.3 Tax Residency Mismatches in the Netherlands

2.5.3.1 Double Deduction

Entities A, B, and C are associated enterprises. Entity B is considered to be a resident for tax purposes both in State I and State II. Entity B makes an interest payment to a third party. In State I, entity B set off this deductible payment against the profits made by entity A, as they form a tax group. In State II, the profits made by entity C are considered to be realized at the level of entity B due to the reverse hybrid character of the former entity. Hence, the deductible payment made by B is offset against the profits realized by reverse hybrid entity C.



The Netherlands as State I

From a Dutch point of view, entity B is considered to be a domestic taxpayer. Since entity B incurred deductible costs, these costs are taken into account within the Netherlands' tax jurisdiction. Due to the applicable group tax regime in the Netherlands (consisting of both entity A and entity B) profits made, and costs incurred are considered as being made by one single taxpayer. As a result, the deductible costs are being offset against the profits made by entity A, regardless of the treatment of entity B in another State. The Netherlands does not provide for any special provision to prohibit a DD outcome as previously demonstrated.

[140] It should be noted that these circumstances are nearly always tools to determine where the actual management is being conducted. See Brood, E. A. (1989). *De vestigingsplaats van vennootschappen*. FM no. 49, Kluwer, Deventer, p. 146.
[141] Supreme Court 17 December 2004, no. 39.719, BNB 2005/105, annex, par. 2.4.

The Netherlands as State II

From a Dutch point of view, entity B is considered to be a domestic taxpayer. Since entity B incurred deductible costs, these costs are taken into account within the Netherlands' tax jurisdiction. Due to the reverse hybrid character of entity C, all profits made by this latter entity are considered to be generated at the level of entity B. For this reason, the deductible costs are being offset against the profits made by entity C, regardless of the treatment of entity B in another State. The Netherlands does not provide for any special provision to prohibit a DD outcome like the one described.

2.6 The Effects of Hybrid Mismatch Arrangements

The technical mechanisms of different types of HMAs have been outlined in the previous sections. In this section, the author will briefly discuss the effects of HMAs for the States involved, with the aim of approaching the lector to the wide scope of consequences that an HMA can trigger.

HMAs are considered to be a form of aggressive tax planning,[142] as MNEs can significantly reduce their overall tax burden by engaging in these cross-border structures.[143] HMAs are harmful to governments, as it has a negative impact on economic efficiency.[144] Furthermore, it leads to a lack of transparency, a distortion of competition, and to an overall loss of tax revenues among governments.[145] HMAs are particularly problematic as it is so difficult to track their existence.[146] Consequently, since in practice a case-by-case assessment of each arrangement is needed to be performed by the tax authorities; governments are hard-pressed with regard to time and resources. Undoubtedly, assessing whether an arrangement is intended to create a mismatch, turns into a resource-intensive operation. Subsequently, although a decrease in the overall tax burden of an MNE inarguably contributes to a reduction of a State's tax revenue, it might be complicated to point out which State is actually affected by the HMA. For instance, in the case of a DD outcome, it is debatable which State actually has a disadvantage in respect of the HMA. Also, considering their size and mobility, MNEs are in a more favorable position to enter into an HMA than small and medium-sized enterprises (SMEs) can. Indeed, the fact that the size of MNEs facilitates the access to HMAs and thus, aids to reduce its overall tax burden, compared to SMEs, could lead to a distortion of competition.

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[142] EC (2012). *Commission Recommendation on Aggressive Tax Planning*, C (2012) 8806 final, par. 2.
[143] EC (2016). *Proposal for a Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164.
[144] OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements*, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 11.
[145] *Ibid.*
[146] Harris, D. (2016). *International tax implications of the organisation for economic co-operation and development proposal to neutralize hybrid mismatch arrangements*. 65 Cath. U. L. Rev. 635, p. 643 – 644. See in this respect also Rosenbloom, H.D. (1999). *International Tax Arbitrage and the International Tax System*. Tax L. Rev., 53, p. 154, who states that "*the task of identifying elements in another country's tax system that are a sufficient source of concern for otherwise available U.S. tax benefits to be limited or denied is difficult, time-consuming, and endless*."

Moreover, HMAs contravene with the principle of tax neutrality. In short, the principle of tax neutrality intents to guarantee that tax considerations do not excessively distort the decision-making process of a company.[147] However, HMAs infract the idea of neutrality as they are an incentive for conducting business activities abroad instead of domestically. Both the considerations where to invest and where to reside are affected, as HMAs can find their origin in disparities between the State of investor (residence State) and the State of investment (source State). Accordingly, both capital import neutrality (CIN) and capital export neutrality (CEN) are affected,[148] leading to artificial movements of taxpayers and capital flows, from, to, or within the internal market, and thus harm its proper functioning.[149]

As a little detour, the question could be raised why we could not have peace with the occurrence of HMAs. An apparent odd question, all the more in the light of the abovementioned. However, HMAs have been used for many years and, thus far, none of the parties involved (*i.e.* the MNE or one of both sovereign States) has countered its occurrence. The States involved appear to have no trouble with the current classification of an entity, or the qualification of a financial instrument. After all, the State could just amend its legislation if they would object the occurrence of HMAs.

This question is actually raised by Van den Bos, who seems to believe that the introduction of measures against HMAs is not self-evident.[150] The author, however, tends to disagree with Van den Bos. Leaving aside the aforementioned arguments, one should note that a State as a "participant" in an HMA should not be considered as a stand-alone entity, but as the embodiment of a society. In the famous words of the political philosopher Rawls, the State can be seen as "*a cooperative venture for mutual advantage […] typically marked by a conflict as well as by an identity of interests*".[151] In this regard, taxes are contributions to this society of which the MNE is part of, and from which the MNE benefits (compare section 3.1.2). The author believes that the public outcry over the aggressive tax planning practices by MNEs clearly show that a State's underlying society reject the use of HMAs. In this light, the author notes a fallacy; it is a false statement that all parties involved appear to have no trouble with the occurrence of an HMA.

2.7 Conclusion; HMAs, a Detrimental Phenomenon for the States Involved

HMAs are caused by the autonomous application of different tax qualification or classification methods among States (without considering the tax classification of the other State), and occur in different ways. The

[147] Knoll, M. S. (2010). *Reconsidering International Tax Neutrality*. Tax L. Rev., p. 99 – 100.
[148] CIN and CET will not be further discussed in this thesis. See for a more in-depth discussion of CIN and CET Ben J.M., Terra and Peter Wattel, J. (2012). *European Tax Law*. Kluwer law international, p. 132 - 135.
[149] EC (2012). *Commission Recommendation on Aggressive Tax Planning*, C (2012) 8806 final, par. 5.
[150] Van den Bos, A.J. (2017). *Hybride mismatch, wat is ertegen?* Nederlands Tijdschrift voor Fiscaal Recht 2017/706.
[151] Rawls, J. (2009). *A theory of justice*. Harvard university press, p. 109.

ATAD distinguishes between (reverse) hybrid entity mismatches, hybrid financial instruments, PE mismatches and tax residency mismatches. Hybrid entity mismatches and reverse hybrid entity mismatches are caused by the autonomous determination of the applicable character traits for a particular legal form. Once two States do not classify an entity in the same way, a hybrid entity mismatch might occur, which could lead to DD outcome, or a D/NI outcome. A financial instrument can operate in an area where the distinction between debt and equity is unclear. When this results in a situation where a payment made is considered to be a profit distribution from the perspective of the State of residence, and, from the perspective of the other State, the payment made is deductible for CIT purposes, one refers to a hybrid financial instrument. A hybrid financial instrument can lead to a D/NI outcome. A PE mismatch occurs when the residence and the PE jurisdictions take a different view as to the allocation of income and expenditure between the PE and head office and include situations where the PE jurisdiction does not treat the taxpayer as having a taxable presence in that jurisdiction. PE mismatch arrangements can be used to produce a DD outcome or a D/NI outcome or lead to a situation where no taxation takes place. Finally, a tax residency mismatch refers to the situation in which an entity is considered to be resident for tax purposes in two States (dual residence), leading to the consequence that a loss or payment can be deducted in both States; a DD outcome. All these types of mismatches are harmful to governments and harm the proper functioning of the internal market, as they negatively impact economic efficiency, lead to a lack of transparency and a distortion of competition, cause a loss of tax revenues and contravene with the principle of tax neutrality.

3. Taxation in the Jurisdiction of Value Creation

In literature, we can encounter different doctrines that explain the allocation of tax jurisdiction. According to them, a State is entitled to exercise its taxing power when there is a sufficient allegiance between that State and the taxable person concerned. In this manner, as indicated in the introduction of this thesis, a State can exercise its right to levy tax on the basis of different legal principles, where the allocation of tax jurisdiction has customarily been attached to the principles of *residence* and *source*.[152]

According to a traditional view, the arrogation of a Member State's tax jurisdiction is not limited by the obligation to implement EU law,[153] and Member States remain largely free to design their direct tax systems so as to meet their domestic policy objectives and requirements.[154] However, by founding or entering the EU, sovereign Member States have expressly or implicitly relinquished to a supranational body all the competencies necessary for the achievement of the objectives for which the EU has been created, in particular, the gradual unification of national economies and their merger into one single market. While in a pre-EU era, tax systems were largely viewed in the context of a single and sovereign jurisdiction, unaffected by tax systems outside their borders,[155] once the EU has been founded, the sovereignty of Member States eroded to a certain degree.[156] Nowadays, Member States are not completely autonomous in respect of direct taxation, since the Court of Justice of the EU (CJEU) requires Member States to exercise their sovereignty consistently with EU law.[157]

Having examined the technical aspects and consequences of HMAs, this chapter is devoted to the concept of tax autonomy. In the course of this thesis, the impact of the implementation of the ATAD will be weighed against a Member State's tax autonomy. Given its intangible character, the concept of tax autonomy is expressed in the light of international allocation principles for the taxation of corporate income, with emphasis on the guiding principle of the OECD BEPS Project. The location of value creation, by reference to the guiding principle of the OECD BEPS Project, where taxation takes place where the value is created, will be developed in this chapter as well. This chapter was referred to as the *normative* aspect of this thesis in *Chapter 1*.

[152] Kemmeren, E. C. C. M. (2006). *Source of income in Globalizing Economies: Overview of the issues and a plea for an origin-based approach*. Bulletin for international taxation, *60*(11), p. 430.
[153] See, for example, CJEU 25 May 1982, Case 96/81, *Commission v. the Netherlands, ECR.,* par. 12.
[154] See COM (2006) 823 final, par. 1.
[155] Musgrave, P. B. (2006). Combining Fiscal Sovereignty and Coordination. *The new public finance: Responding to global challenges*, p. 167.
[156] "*While the right to territorial integrity has been strengthened since the end of World War II, since that time also a steady erosion of State sovereignty can be detected due to the emergence of international organizations that are entrusted by the participating states with the exercise of public power on their behalf*." See Amtenbrink, F., Raulus, R. (2010). *Contribution to: Fiscal Policy in the European Union Context – The Semi-detached Sovereignty of Member States in the European* Union, p. 3 – 4.
[157] CJEU C-270/83, *EC vs French Republic*. See in this respect also CJEU C-279/93, *Schumacker*, par. 21.

3.1 Tax Autonomy Benchmark; a Parse of the Concept

The concept of autonomy reflects the independence of external control or influence. In other words, an autonomous State is independent of external governance. Derived from this terminology, autonomy can be translated as the attribute of statehood; an autonomous State is a body which exercises the legal order with imperative authority.[158]

3.1.1 The Principle of Sovereignty

In an autonomous State, governments attribute and exercise their own taxing powers.[159] The legal justification for the right to impose taxes and, therefore, the assignment of tax jurisdiction amongst States is generally considered to be the *principle of sovereignty*.[160] This principle can be defined as a State's inviolable right of self-determination within a specific territory and political community.[161] Tax sovereignty reflects the inseparable relation between the sovereign State and its inherent prerogative and authority to levy taxes within its territorial jurisdiction, as recognized by international tax law.[162] This authority is, in turn, to be exercised in a legitimate way and in compliance with legal principles.[163]

According to Martha, the principle of sovereignty must serve as the most fundamental and basic test in matters of international taxation: "*a State may only fiscally attach those facts that are subject to its supremacy (sovereignty)*."[164] Martha distinguishes between personal and territorial sovereignty.[165] He states that personal sovereignty of a State comprises the right to extend its laws to regulate conduct and to attach legal consequences to the conduct of individuals, wherever these individuals may be.[166] Martha continues that "*a legal relation exists between a State and individuals by virtue of their nationality [or incorporation] conferred on them by the State according to its domestic law*."[167] Under the personal sovereignty principle, a legal relation continues even if the nationals [or corporations] of a given State leave the territory of that

[158] Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.1, p. 18 – 19.
[159] Traversa, E. (2011). *Is there still room left in EU law for tax autonomy of member states' regional and local authorities*. EC Tax Rev., 20, 4, p. 57.
[160] Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.1, p. 18. With reference to Gribnau, J.L.M. (1998). *Rechtsbetrekking En Rechtsbeginselen in het Belastingrecht*. Rechtstheoretische Beschouwingen over Navordering, Toezegging en Fiscale Vaststellingsovereenkomst, p. 83 – 103.
[161] Jansen, S.J.J.M. (2011). The future of fiscal sovereignty: Some closing thoughts. Fiscal Sovereignty of the Member States in an Internal market, Kluwer Law International, p. 233.
[162] Barents, R. (2011). *The single market and national tax sovereignty*. Fiscal Sovereignty of the Member States in an Internal market, p. 58.
[163] Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.1, p. 18. See in this respect also Gribnau, H. (2012). *Legislative instrumentalism vs. legal principles in tax law*. International Tax Law Review; Dworking, R. (1977). *Taking Rights Seriously*. London, Duckworth; and Dworkin, R. (1986). *Law's Empire*. Cambridge (Mass.) / London: Harvard University Press.
[164] Martha, R.S.J. (1989). *The jurisdiction to tax in international law: theory and practice of legislative fiscal jurisdiction* (Vol. 9). Kluwer Law International, p. 43.
[165] Martha distinguishes a third kind of sovereignty: functional sovereignty. This refers to the fiscal jurisdiction over *e.g.* offshore mineral activities such as maritime mining operations, and taxation of air transport activities in flight information regions. This form of sovereignty will be disregarded in this thesis. *Ibid*. p. 110 – 138.
[166] *Ibid*. p. 43 – 44.
[167] *Ibid*. p. 44.

State.[168] Territorial sovereignty, on the other hand, comprises the power of a State to exercise supreme authority over all individuals, corporations, and things within its territory.[169]

3.1.2 The Direct Benefit Principle

Derived from the principle of sovereignty, taxation should be perceived as a contribution which flows from the relationship (or allegiance) between a State and an individual, whereby the State itself determines the extent of its taxing rights.[170] In the author's view, the principle of sovereignty on itself solely reflects an allegiance between a certain State and an individual, irrespective of what this allegiance comprises. The principle of sovereignty does not rule on whether a *sufficient allegiance* exists that would justify tax jurisdiction. In this respect, the prohibition of arbitrariness in international law should be taken into consideration. Arbitrariness is considered to be present when there is no sufficient allegiance with the relevant State and that State nevertheless imposes tax.[171]

In order to determine whether a sufficient allegiance for assigning tax jurisdiction is present, a linkage should be made between the principle of sovereignty and the *direct benefit principle*. The direct benefit principle reflects the idea that the payment of taxes are a consideration by all taxpayers for the totality of state services provided by that State.[172] The to the direct benefit principle underlying benefit theory affirms that a State's tax claim is legitimate or can be justified only in those cases in which taxes are understood as a consideration for benefits provided to the individual through state activities.[173]

3.2 The Basic Principle of the OECD BEPS Project and the ATAD

The objective being formulated in the OECD BEPS Project is to ensure that profits are taxed where economic activities take place and value is created. This guiding principle is not further substantiated in the BEPS Action Plan, nor in the Discussion Drafts or Deliverables on these Actions.[174] Neither the ATAD – the EU's transposition of the OECD BEPS Project – elucidate on this aim.[175] Now, the EU has adopted

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[168] *Ibid*. p. 44.
[169] *Ibid*. p. 45.
[170] *Ibid*. p. 19.
[171] *Ibid*.
[172] Vogel is of the opinion that the direct benefit principle is the sole justification for taxation. See Vogel, K. (1988). *Worldwide vs. source taxation of income-A review and re-evaluation of arguments* (Part III). *Intertax, 16*, p. 393 – 394.
[173] Heeren, P. (2016). *Sustainability of the Arm's Length Principle as the Basis for International Income Allocation in a Digitalising Economy*, par. 4.1.2.1, p. 31. With reference to Vogel, K. (1988). *Worldwide vs. source taxation of income-A review and re-evaluation of arguments* (Part III). *Intertax, 16*, p. 394.
[174] OECD (2014). OECD/G20 Base Erosion and Profit Shifting Project: Explanatory Statement, par. 1, p. 4. We read that: "the current rules have revealed weaknesses that create opportunities for Base Erosion and Profit Shifting (BEPS), thus requiring a bold move by policymakers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created."
[175] EC (2017*). Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164, par. 2 of the preamble. We read that: "*the Council conclusions stressed the need to find common, yet flexible, solutions at the EU level consistent with OECD BEPS conclusions*." One can conclude that the ATAD 1 and 2 were created as a direct result of the OECD BEPS Project. Hence, the overall aim of the ATAD can be considered to be in accordance with the OECD BEPS Project.

virtually the same objective as a guiding principle: "*ensuring that tax is paid where profits and value are generated*."[176]

Although the recommendations of BEPS Action 2 or the EU measures against HMAs do not further elaborate on this overall objective, they are considered to pursue this aim (or at least not counteract it) as they are components of the OECD BEPS Project respectively the ATAD.[177] Therefore, it is relevant to examine whether the ATAD contributes to this objective.[178] Under the following sections, a sound principle-based approach towards this guiding principle of the OECD BEPS Project and the ATAD will be developed in order to evaluate whether the ATAD is in line with the objective of the OECD BEPS Project.

3.2.1 A Division of International Taxing Rights

As shown under section 3.1, a tax justification ground (or sufficient allegiance) is considered to be present when there is an allegiance between the individual and a State (principle of sovereignty), who benefits from the services provided by that State (direct benefit principle). In the author's view, a sufficient allegiance can reveal itself through a social, political, or economic connection with the State concerned, as will be shown in the following paragraphs. A mere social or political allegiance is an insufficient basis for tax jurisdiction with respect to corporate income. Therefore, – in the search for a sound principle-based approach towards the guiding principle of the OECD BEPS Project and the ATAD – a social or political allegiance should be disregarded. Instead, attachment will be found to the concept of source country entitlement or the underlying *economic allegiance-theory* as being developed by Schanz.[179]

3.2.1.1 Social Allegiance; Taxation on the Basis of Residence

The concept of residence reflects the idea that a State is entitled to impose tax on individuals, residing in that State. The State of residence is often considered to have the best rights to tax.[180] Indeed, most States, including the Netherlands, use the concept of residence as the first and privileged criterion to assess whether a person has a sufficient allegiance with its jurisdiction (compare section 2.1.6 for the concept of residence

[176] Although expressed in a slightly different way, the objective of the ATAD and the OECD BEPS Project are considered to be equivalent.
[177] Only 3 out of 15 Action plans expressly state the overall objective of the OECD BEPS Project. Consider in this respect Action 8 regarding intangibles, Action 9 regarding risks and capital, and Action 10 regarding other high-risk transactions; OECD (2013). *Action Plan on Base Erosion and Profit Shifting*, p. 20.
[178] The lector is reminded that, for the sake of clarity, any reference in this thesis to the ATAD refers to both the ATAD before and after its amendment, unless otherwise stated.
[179] Schanz, G. (1892). *Zur Frage der Steuerpflicht*. FinanzArchiv/Public Finance Analysis. See in this respect also Kemmeren, E.C.C.M. (2006). *Source of income in Globalizing Economies: Overview of the issues and a plea for an origin-based approach*. Bulletin for international taxation, *60*(11), p. 434.
[180] Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.3.1.3, p. 31.

from a Dutch perspective).[181] The easy assessment, audit, and execution of the obligations of a taxpayer are mentioned to allocate tax jurisdiction with respect to income taxes to the State of residence of the taxpayer.[182] In the author's view, the relationship between the taxpayer and the State due to residency is considered to be an allegiance with a social character, since an individual generally resides in the State where they have their *center of vital interests*. One could argue that the State provides the public goods, facilitating an individual's living environment. Hence, a social allegiance between an individual and a State is in place on the basis of residence.

Despite that a sovereign State is entitled to impose tax on corporations that reside within its jurisdiction, it should be noted that residence as such does not create income nor enables the possession of wealth.[183] Instead, as rightly mentioned by Kemmeren, residing is a way of consuming the income produced.[184] Therefore, residence offers a basis for allocation of tax jurisdiction with respect to consumption, rather than with respect to the production of corporate income.[185] Indeed, especially in cross-border situations, *i.e.* in situations where the *source* of income finds its origin in another jurisdiction, there is a lack of allegiance between, on the one hand, the State wherein an MNE *resides*, and, on the other hand, the business activities generating corporate income, carried out by that MNE. Hence, taxation based on a mere social allegiance between a State and an MNE is an inadequate interpretation of the guiding principle of the OECD BEPS Project and the ATAD. In other words, the place of residence is not always the location where profits and value are generated.

Another flaw of the principle of residence is the arbitrary character of its definition.[186] The two dominant model tax conventions, being developed by the OECD and the United Nations (UN), codify that corporations are deemed resident in the State in which they are liable to tax by reason of its POEM or any similar criterion.[187] However, unlike natural persons, MNEs do not generally reside in the State where they have their center of vital interests.[188] Instead, MNEs comprise complex relationships through which various actors

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[181] *Raad, C. V., & Pötgens, F. P. G. (2013). Cursus Belastingrecht Internationaal Belastingrecht,* par. 0.2.1.
[182] *Ibid. With reference to League of Nations: Technical Experts to the Economic and Financial Committee (1925)*. Double Taxation and Tax Evasion – Report and Resolutions submitted by the Technical Experts to the Financial Committee – Document F.212 – Legislative History of United States Tax Conventions, p. 8. We read: "*In order to avoid double taxation, the best means would be to accept residence as a basis of the tax on income. They [the Committee] recognise, however, that the application of this principle could not be expected completely to preclude all taxation according to its origin of income derived from landed property or even from commercial or industrial enterprises.*"
[183] Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models.* Tilburg University, School of Economics and Management, par. 2.3.3.1.3, p. 31.
[184] *Ibid.*
[185] *Ibid.*
[186] Cavelti, L.U., Jaag, C. and Rohner, T.F. (2017). *Why Corporate Taxation Should Mean Source Taxation: A Response to the OECD's Actions against Base Erosion and Profit Shifting*, 9 World Tax Journals IBFD, p. 355 – 360.
[187] Article 4, par. 1 of both the OECD MC and the UN MC state that for the purposes of the Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.
[188] Article 4, par. 2(a) and (b) of the OECD MC and the UN MC.

conduct economic activities to generate income. Due to the absence of a principal place of abode, it has the preference that MNEs are taxed according to the place where they effectively conduct relevant business activities. When taxing MNEs on the basis of a fictional place of residence as if they were individuals, MNEs could move their residence to States with preferential tax regimes without having economic substance in those respective States.

3.2.1.2 Political Allegiance; Taxation on the Basis of Nationality, Citizenship or Incorporation

In most States, the nationality or citizenship principle is of complementary relevance, compared to the residence principle. Usually, one's nationality is only of relevance in those cases where tax avoidance is likely to occur. Only occasionally (taking the US as foremost example), the nationality or citizenship principle is used as a general tax justification ground. In the US, citizenship or nationality is viewed as a form of insurance policy, allowing the holder to assume residence in the US at any time and to enjoy the protection of the US wherever needed.[189] This insurance, in the view of the US, justifies taxation of non-resident citizens.[190] In this light, the relationship between taxpayer and State due to nationality or citizenship is considered to be an allegiance with a political character. However, by its nature, nationality or citizenship are in theory only of relevance for natural persons rather than for MNEs. Hence, as the scope of this thesis is limited to MNEs, the taxation rights on the basis of nationality and citizenship are of no relevance and they will be no further discussed.

Under the incorporation principle, nationality or citizenship is not attached to natural persons, but awarded to legal persons.[191] According to this principle, a legal person derives its origination, continuation, and cessation from the laws of the State where it has been incorporated (compare section 2.1.3 for the concept of incorporation from a Dutch perspective).[192] The place of management, as a rule, is not relevant under an incorporation system.[193] One could argue that taxation on the basis of incorporation is justified because the entity involved benefits from the civil law system of the State concerned. Corresponding to the principle of nationality or citizenship, a relationship between a taxpayer and a State due to incorporation under national law is considered to be an allegiance with a political character.

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[189] Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.3.1.1, p. 28.
[190] *Ibid*. With reference to Doernberg, R. L., & van Raad, K. (1992). *The forthcoming US Model Income Tax Treaty and the saving clause*. Tax Notes International, 5, p. 775 – 782.
[191] See in this respect Strik, S.A.W.J., de Vries, N.H., Doornebal, J., Kok, Q.W.J.C.H., Koster, H., Pötgens, F.P.G., & Vleggeert, J. (2010). *Cursus belastingrecht. Vennootschapsbelasting.-Studenteneditie*, par. 1.0.2.c.
[192] See *e.g.* Irelend, the Netherlands, Switzerland, the UK and the US. See in this respect Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.3.1.2, p. 29.
[193] *Ibid*.

Nonetheless, a mere political allegiance should be considered as an insufficient basis for tax jurisdiction with respect to the production of corporate income as well. Indeed, likewise residence, incorporation does not produce corporate income. However, in the light of the direct benefit principle, it is arguable that a State may demand a contribution from an entity, because that entity benefits from the civil law system of the State concerned. As pointed out by Kemmeren, it seems inappropriate to assign taxing rights on corporate income on the basis of this argument.[194] A registration fee or a yearly registration tax on its registration as an entity can be considered as being appropriate.[195]

3.2.1.3 Economic Allegiance; Taxation on the Basis of Source

If MNEs are to be taxed on their corporate income, and if the right to tax their corporate income must be geographically allocated between different States, there is no preference to tax MNEs on a fictional place of residence as if they were individuals, neither there is a preference to tax MNEs on the basis of incorporation under national law as if an entity bears nationality.[196] Rather, in the light of the guiding principle of the OECD BEPS Project, an MNE should be taxed in the State of *source*: the place where corporations effectively conduct relevant business activities.[197]

The term *source* is used for a motley collection of justifications for the allocation of tax jurisdiction.[198] One could consider the concept of source as an elaboration of the principle of location of wealth (*situs*): a person who receives income from a person or property situated in a State has such a close relationship with the State where that person or that property is *physically* located, that in fact, from this relationship an obligation to support that State is justified.[199] The relationship between the object of the tax and the relevant territory is of importance.[200] Indeed, income is produced only if a person utilizes the production factors labor and capital.[201] The taxation of income or capital should be linked, as much as possible, with this utilization and therefore also with the place where these factors are utilized.[202] Such a linkage is regularly found when a PE is in place (compare section 2.4.3 for the PE concept from a Dutch perspective).

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[194] Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.3.1.2, p. 30.
[195] *Ibid*.
[196] Cavelti, L.U., Jaag, C. and Rohner, T.F. (2017). *Why Corporate Taxation Should Mean Source Taxation: A Response to the OECD's Actions against Base Erosion and Profit Shifting*, 9 World Tax Journals IBFD, p. 372.
[197] Kemmeren, E.C.C.M. (2006). *Source of income in Globalizing Economies: Overview of the issues and a plea for an origin-based approach*. Bulletin for international taxation, *60*(11), p. 447 – 449.
[198] Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.3.1.4, p. 33.
[199] *Ibid*. par. 2.3.3.1.4, p. 34.
[200] Martha, R.S.J. (1989). *The jurisdiction to tax in international law: theory and practice of legislative fiscal jurisdiction* (Vol. 9). Kluwer Law International, p. 99.
[201] Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.2, p. 21.
[202] *Ibid*.

Taxation on the basis of source is consistent with the direct benefit principle, whereby source-based tax profits are viewed as a *quid pro quo* for public infrastructure, protection of property rights, and services provided for businesses by the source country, which are all essential preconditions for an investor to generate corporate income.[203] Presumably, an MNE receives public spending benefits in jurisdictions where its employees are located. For instance, their employees have access to public infrastructure and therefore, can commute to work; moreover, they can benefit from national health care schemes or environmental regulation.[204] In this light, reliance on public services facilitates the creation of value by the MNE.[205]

Hence, when it comes to the allocation of taxing rights on corporate income, taking into consideration the aforementioned, economic allegiance prevails over social or political allegiance, as it is assumed that the former reflects the guiding principle of the OECD BEPS Project and the ATAD: "*the place where the economic activities generate profits, and value is created*." Reworded, the magnitude of the taxing rights of a State is merely determined by the income earned or capital situated inside that State.[206] The entitlement to impose taxation based on the concept of source, which, for the purpose of this thesis, will be referred to as *source country entitlement*, will be considered as the location *where value is created*, and it will serve as the starting point of this thesis.

3.3 Source Country Entitlement; the Place where Value is Created

There may be a consensus among scholars that the source of corporate income is not located (or not per se located) in the State of residence or incorporation. However, there seems to be no consensus on where the source of corporate income is located (*i.e.* where value creation takes place). This is also recognized by Vogel: "*[the concept of] source is unambiguous only in what it excludes: taxation based on source is different from taxation based on residence or on citizenship [or incorporation].*[207] *The only positive statement that can be made*," as Vogel continues, "*is that the concept of source refers to a State that in some way is connected to the production of the income in question, to the State where value is added to a good*."[208]

Some of the ideas in the OECD BEPS Project may be clear and specific, but the concept of value creation is definitely not one of them. Instead, the guiding principle of the BEPS Project seems to raise unanswerable questions. For example, who or what is creating value for the MNE, and, as a result, where is this value

[203] Smit, D.S. (2017). *International Income Allocation under EU Tax Law: Tinker, Tailor, Soldier, Sailor*.EC Tax Review, 26(2), p. 68. With reference to EC (1992). *Report of the Committee of Independent Experts on Company Taxation*, p. 37.
[204] Morse, S.C. (2018). *Value Creation: A Standard in Search of a Process*, 72 Bull. Intl. Taxn. 4/5, Journals IBFD, p. 196.
[205] See Avi-Yonah, R. S., & Xu, H. (2017). *Evaluating BEPS*. Erasmus L. Rev., 10, 3, p. 3 – 11;
[206] Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.3.2.2, p. 52.
[207] Vogel, K. (1988). *Worldwide vs. source taxation of income-A review and re-evaluation of arguments* (Part I). *Intertax*, *16*, p. 223.
[208] *Ibid*.

created? The ambiguity created by the lack of elaboration by the OECD on the concept of value creation inevitably leads to different conceptions on how to determine the jurisdiction of value creation.[209]

3.3.1 Employee Location as a Basis for Value Creation

In his plea for an origin-based approach, Kemmeren states that *only* individuals can create income.[210] The intellectual element is the key component in the production of income. Through the action of an individual, value may be added to things.[211] Although every type of income or value creation could theoretically be attached to (indirect) human intervention, the question remains open about which part of value creation should be linked to each individual. While the author acknowledges that an origin-based approach – based on the location of the individual that actually adds value to goods or services – most accurately reflects the idea of taxing where value is created, it should be noted that it may be difficult, if not impossible, to link income with the location of a value-creating or productive activity.[212]

3.3.2 Consumer Location as a Basis for Value Creation

Rather than embracing an origin-based approach, one could link the location of value creation to the basis of consumer location.[213] From an efficiency perspective, the latter approach prevails over an origin-based approach.[214] Even though convenience might not be the predominant argument for the allocation of tax jurisdiction,[215] the OECD seems to consider this approach as an appropriate value driver in the context of transfer pricing, and lists consumer location as a profit allocation factor for the application of the arm's length principle.[216]

One could claim that value creation declines to adopt a sales-based approach as the interaction between company and consumer should not be seen as a source of value creation.[217] Instead, *value exchange* and

[209] Heeren, P. (2016). *Sustainability of the Arm's Length Principle as the Basis for International Income Allocation in a Digitalising Economy*, par. 4.2, p. 34.
[210] Kemmeren, E. C. C. M. (2006). *Source of income in Globalizing Economies: Overview of the issues and a plea for an origin-based approach*. Bulletin for international taxation, *60*(11), par. 2.3.1.1, p. 434. With reference to Graetz, M. J., & O'Hear Michael, M. (1996). *The original intent of US international taxation*. Duke lJ, 46, 1021.
[211] *Ibid.*
[212] *"The idea that income has a locatable source seems to be taken for granted, but the source of income is not a well-defined economic idea. Income does not come from some place, even though we may construct accounts to approximate it."* See Ault, H. J., & Bradford, D. F. (1990). *Taxing international income: An analysis of the US system and its economic premises.* In Taxation in the global economy, University of Chicago Press, p. 11 – 52.
[213] See, for example Auerbach, A. J., Devereux, M. P., Keen, M., & Vella, J. (2017). *Destination-based cash flow taxation*. Oxford University Centre for Business Taxation.
[214] Morse, S.C. (2018). *Value Creation: A Standard in Search of a Process*, 72 Bull. Intl. Taxn. 4/5, Journals IBFD, p. 198.
[215] This is also acknowledged by Kemmeren. See Kemmeren, E.C.C.M. (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*. Tilburg University, School of Economics and Management, par. 2.3.3.1.3, p. 31 – 32.
[216] OECD (2015). *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 1.144, p. 44.
[217] See, for example Normann, R., & Ramirez, R. (1993). *From value chain to value constellation: Designing interactive strategy*. Harvard business review, 71(4), p. 65 – 77; Wikström, S. (1996). *Value creation by company-consumer interaction*. Journal of Marketing Management, 12(5), p. 359 – 374.

extraction are the primary functions of the interaction between company and consumer, which should be separated from the value creation process.[218] Although this might be true in most cases, it is worth mentioning that this traditional view is challenged by the trend of digitalization. The increased involvement of the consumer in the process of value creation is an important characteristic of the digitalizing economy,[219] or, to quote Prahalad and Ramaswamy, "*informed, networked, empowered, and active consumers are increasingly co-creating value with the firm*."[220] The market can no longer be viewed as separate from the process of value creation as a locus of exchange or an aggregation of consumers.[221] Such an approach is also supported by the general idea of economic allegiance.[222] Schön stated in this context firmly that "*it cannot be disputed that the existence of a customer base in a territory, leading to the transfer of financial means from the customers to the taxpayer, forms a strong economic allegiance*."[223] It is true to say that, even though the consumer might take part in the value creation process of *data-based* business models – of which Google and Facebook are the most evident examples – the lector is invited to take note that an approach based on consumer location inadequately reflects value creation in most other business models, such as business models based on the production of tangible goods.

Moreover, it is noted by Burgers that the OECD does not renounces the existing allocation system for corporate income under the digitalization trend.[224] Even though businesses are carried out differently in a digitalized economy relative to a traditional economy – meaning that essential functions may be shifted to the consumer – the OECD preserves the traditional allocation rules for corporate income such as the concept of residence and the concept of source.[225]

3.3.3 Other Value Drivers as a Basis for Value Location

For value creation that cannot be traced back to a specific employee or consumer, the amount of value creation is likely to be split between two or more jurisdictions.[226] For instance, depending on the nature of the value driver, the localization will be limited to specific parts of the business, and thus, it would be limited

[218] Prahalad, C. K., & Ramaswamy, V. (2004). *Co-creation experiences: The next practice in value creation.* Journal of interactive marketing, 18(3), p. 6.
[219] This involvement is particularly enhanced by the reliance on data and the existence of network effects. See Heeren, P. (2016). *Sustainability of the Arm's Length Principle as the Basis for International Income Allocation in a Digitalising Economy*, par. 4.2.2.1, p. 37.
[220] Prahalad, C. K., & Ramaswamy, V. (2004). Co-creation experiences: The next practice in value creation. *Journal of interactive marketing*, *18*(3), p. 6.
[221] Heeren, P. (2016). *Sustainability of the Arm's Length Principle as the Basis for International Income Allocation in a Digitalising Economy*, par. 4.2.2.1, p. 37. With reference to Prahalad, C. K., & Ramaswamy, V. (2004). Co-creation experiences: The next practice in value creation. *Journal of interactive marketing*, *18*(3).
[222] *Ibid.*
[223] Schön, W. (2009). *International tax coordination for a second-best world (part I)*, par. 3.3.1.1, p. 92.
[224] Burgers, I.J.J. (2018). '*Waardecreatie': nieuw(e) mantra, concept, standaard of beginsel*. NTFR Beschouwingen, p. 6.
[225] *Ibid.*
[226] See in this respect the illustrative explanation of Heeren. He elaborates on the challenges of localizing value creation in a digital economy. Heeren, P. (2016). *Sustainability of the Arm's Length Principle as the Basis for International Income Allocation in a Digitalising Economy*, par. 4.2.2.2, p. 37 – 39.

to specific jurisdictions in which the MNE is active. A value driver could, for example, be based on the location of production capacity, the location of daily management, the location where capital is raised, the location where risk is borne, or a combination of these or other factors.[227] Such an approach would require the identification of different elements of the profit generated, allocating them to different value drivers. In this manner, it is crystal clear that accurate value creation per jurisdiction is difficult, if not impossible.

3.4 Conclusion; Allocation Principles, the Building Blocks for a Tax Autonomous State

In this chapter, an attempt was made to elucidate on the concept of tax autonomy. Attachment to existing principles was sought and found, and two international allocation principles for the taxation of corporate income have been distinguished. The principle of sovereignty and the direct benefit principle were identified as fundamental building blocks for a tax autonomous State. More specific, the concept of residence, incorporation, and source appear to be their underlying tax justification grounds.

Additionally, the author intended to create a benchmark based on the guiding principle of the OECD BEPS Project. One should perceive value creation, as much as possible, as a direct result of the utilization of the production factors by human intervention. In this light, the place of value creation should be linked with the place of human intervention.

In the course of this chapter, it has been shown that source country entitlement can serve as an interpretation of the place where value is created. Nevertheless, the actual determination of the essential factors of value creation has proven to be difficult. The author provides for some indicators that could be linked up to source country entitlement, such as employee location, consumer location, and other value drivers such as the location of production capacity, the location of management, the location where risk is borne, or the location where capital is raised. An irrefutable benchmark of the place where value is created is missing, allowing the author to provide for a balanced analysis based on hypothetical cases in the subsequent chapters.

[227] Morse, S.C. (2018). *Value Creation: A Standard in Search of a Process*, 72 Bull. Intl. Taxn. 4/5, Journals IBFD, p. 196.

4. BEPS Action 2: Neutralizing the Effects of HMAs

The 15 Actions introduced by the OECD in its BEPS Project[228] in July 2013 focus on the problem of the "*increased segregation between the location where actual business activities and investment take place and the location where the profits are reported for tax purposes.*"[229] The objective of the OECD BEPS Project is – as stated in *Chapter 1* and *Chapter 3* – to reverse this phenomenon by establishing rules and systems which ensure that "*profits are taxed where the economic activities generating the profits are performed and where value is created.*"[230] BEPS Action 2 contributes to this process by establishing "*a fundamentally new set of standards designed to establish international coherence in corporate income taxation.*"[231] Against this background, HMAs have been identified, inter alia, as key factors for BEPS outcomes, triggering the OECD to develop a set of recommendations in the form of specific rules that governments can include in their domestic laws.[232]

Although the problems arising due to HMAs could be addressed at its cause by harmonizing the classifications of entities, and the qualification of financial instruments on supranational level,[233] the OECD, at least for now, aims to neutralize the mismatch outcomes by recommendations for international coordinated linking rules.[234] These linking rules make the tax treatment of an instrument or entity in one State dependent on the tax treatment of that instrument or entity in the other State. By doing so, "*mismatches due to the lack of coordination of the tax laws in the States involved shall be eliminated*", as stated in BEPS Action 2.

In the interest of providing clarity, eighteen pages in BEPS Action 2 are devoted to definitions.[235] Yet, in the author's view, much technical complexity is embedded in BEPS Action 2, and many defined terms have to be unraveled to assimilate each recommendation. Another factor that detracts the comprehensibility of

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[228] OECD (2013). *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Paris.
[229] OECD (2013). *Addressing Base Erosion and Profit Shifting*, OECD Publishing, Paris.
[230] OECD (2015). *Explanatory Statement*, OECD/G20 Base Erosion and Profit Shifting Project, p. 4; and OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 3.
[231] OECD (2013). *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Paris, p. 15.
[232] The OECD report is divided into two parts. First, their recommendations cover amendments in a State's domestic law. Secondly, recommendations on treaty issues are discussed. This thesis only covers the recommendations regarding domestic law amendments. See OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements*, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 13 and p. 133.
[233] Mismatches in the legal qualification of entities or payments, leading to double taxation or double non-taxation, would be eradicated in relations amongst companies applying common corporate tax rules. See EC (2011). *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*. COM (2011) 121 final, p. 2 – 4.
[234] OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 16.
[235] OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 113 – 131.

BEPS Action 2 is that the recommendations are grouped and presented to the lector based on the outcome of the HMA (*i.e.* a DD outcome or a D/NI outcome). Instead, it would be more useful for users to construct the rules around the types of HMAs, rather than the types of outcomes. Hence, it is the intention to disentangle the in-depth discussed combinations of primary, secondary, and specific rules. This chapter aims to provide for a more transparent overview of the technical aspects of BEPS Action 2, categorized per type of HMA.

This chapter presents the technical aspects of BEPS Action 2 in general terms in the sections 4.1 to 4.6. First, the delimitation of BEPS Action 2 will be covered under section 4.1. Hereinafter, attention will turn to the recommendations of BEPS Action 2. In section 4.2, the BEPS Action 2 recommendations regarding hybrid entities will be covered. Section 4.3 covers the BEPS Action 2 recommendations with respect to reverse hybrid entities. Section 4.4 provides for the BEPS Action 2 recommendations against hybrid financial instruments. Section 4.5 and section 4.6 will eventually discuss the BEPS Action 2 recommendations regarding PE mismatches and tax residency mismatches respectively. Subsequently, section 4.7 discusses some political thoughts about the OECD BEPS Project, and, more specific, BEPS Action 2 from a Dutch point of view.

After observing the BEPS Action 2 recommendations, one will note that the changes that BEPS Action 2 requires are not insignificant. Moreover, it is not obvious that the changes that BEPS Action 2 could require contribute to the concept of source country entitlement. In this respect, an attempt will be made to put together the greater and the lesser in section 4.8, *i.e.* the guiding principle of the OECD BEPS Project and the BEPS Action 2 recommendations. This section, therefore, briefly assesses whether the concept of source country entitlement is advanced or compromised by the BEPS Action 2 recommendations. Conclusions will be drawn up under section 4.9.

This chapter was referred to as the *descriptive* aspect of this thesis in *Chapter 1*. However, this chapter will have *contemplative* characteristics in section 4.8, as the BEPS Action 2 recommendations will be reviewed in the light of the concept of source country entitlement. The technical aspects of HMAs are considered to be known to the lector, as they have been discussed in *Chapter 2*. The technical aspects of HMAs will therefore only be discussed to the necessary extent.

4.1 The Delimitation of BEPS Action 2

The rules being proposed by the OECD are grouped based on the outcome of the HMA. In BEPS Action 2, the OECD distinguishes between a deduction in one State, that is not offset by the inclusion of an amount of income in another State (*i.e.* a D/NI outcome), and a deduction that is claimed for the same amount in two states (*i.e.* a DD outcome). The BEPS Action 2 recommendations have a scope limited to arrangements between *related persons*, and to payments made under a *structured arrangement*.[236] Presumably, transactions between related persons or within the same control group are undertaken with a certain degree of care and planning, such that the benefits arising from the hybrid outcomes are unlikely to be unintentional. Similarly, the concept of a structured arrangement is intended to capture transactions that are structured based on the hybrid outcomes. For comparison purposes with the scope of the ATAD in *Chapter 5*, the scope of BEPS Action 2 will be briefly touched upon.

4.1.1 Related Persons

According to recommendation 11 of BEPS Action 2, two persons are considered to be related if the first person has a 25% or higher investment in the second person, or when a third person holds an investment of 25% or more in both persons.[237] This test measures both direct and indirect investments, which includes both voting rights and the value of any equity interest.[238] Persons who are acting together in respect of the ownership of an investment in certain circumstances are required to aggregate their ownership interests for the purposes of the related party test.[239]

Recommendation 11 also states that persons are related parties when they are part of the same control group. Two persons are in the same control group if:[240]

(i) these persons are *consolidated* for accounting purposes;

A subsidiary entity should be treated as related to its ultimate parent if the subsidiary is required to be consolidated, on a line-by-line basis in the parent's consolidated financial statements prepared under International Financial Reporting Standards (IFRS) or applicable local Generally Accepted Accounting Principles (GAAP).[241]

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[236] Except for the recommendations regarding a DD outcome due to a PE mismatch and the recommendations regarding a deemed branch payment, which both shall give rise to a PE mismatch only to the extent the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income. The recommendation regarding tax residency mismatches as laid down in chapter 7 of the BEPS Action 2 report has no limitation of scope. See OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 96 – 102, p. 42 – 44, p. 77, and par. 312, p. 101; OECD (2017). *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 81 – 84, p. 40 – 42.

[237] OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, recommendation 11.1(a), p. 113.

[238] *Ibid.* par. 350 and 354, p. 114.

[239] *Ibid*.

[240] *Ibid.* par. 362, p. 116.

[241] *Ibid.* par. 363, p. 116.

(ii) the first person has an investment that provides that entity with *effective control* over the second person or there is a third person that holds investments which provides that person with effective control over both persons;

Entities are members of the same control group if the first entity can effectively control the second entity through an investment in that entity or if there is a third entity that has a sufficiently significant investment in both entities that gives it an effective control over both of them.[242]

(iii) the first person has a 50% or greater investment in the second person or there is a third person that holds a 50% or greater investment in both; or

Persons are treated as part of the same control group if one person holds at least a 50% investment in the other or the same person holds at least a 50% investment in both.[243]

(iv) they can be regarded as associated enterprises under Article 9 of the OECD MC.[244]

According to Article 9.1 of the OECD MC, associated enterprises are found "where an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise [entity] of the other Contracting State, or the same persons participate directly or indirectly in the management control or capital enterprise of a Contracting State and an enterprise of the other Contracting State."

4.1.2 Structured Arrangement

One could escape the *related persons-criteria* by making use of an independent third party as a middleman. A telling example of such a structure is a hybrid financial instrument mismatch, which is deliberately diverted via *e.g.* a financial institution.[245] This is why BEPS Action 2 also counters structured arrangements, even when they are not directly entered into by related parties. The concept of a structured arrangement is defined in recommendation 10 of BEPS Action 2. The term covers "*any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch*."[246] Yet, even though the concept of a structured arrangement focusses on the *deliberate exploitation* of hybrid mismatches, the test for whether an arrangement is structured is objective. It applies, therefore, regardless of the parties'

[242] *Ibid.* par. 364, p. 116.
[243] *Ibid.* par. 365, p. 116.
[244] *Ibid.* p. 113.
[245] *Ibid.* example 10.2, p. 435.
[246] *Ibid.* recommendation 10.1, p. 105.

intentions, whenever the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch in tax outcomes.[247]

4.2 Recommendations Regarding Hybrid Entity Mismatches

4.2.1 Hybrid Entity Mismatches with a DD Outcome

Recommendation 6 of BEPS Action 2 applies to a situation corresponding with the situation discussed under section 2.1.1. In such occasion, a payment made[248] results in an HMA with a DD outcome when that payment is deductible under the laws of the *payer jurisdiction* and *parent jurisdiction*. Recommendation 6 uses the terms payer jurisdiction and parent jurisdiction to distinguish between the jurisdictions where the deduction and the duplicate deduction arises. The duplicate deduction in the parent jurisdiction results from the hybrid character of the entity making the payment. Indeed, since the payer entity is treated as transparent by (one of) its investor(s)[249] in the parent jurisdiction, the payment is – from the perspective of the parent jurisdiction – considered to take place at the level of the parent. At the same time, the payer entity is treated as non-transparent in the payer jurisdiction. Hence, from the latter perspective, the payment is considered to take place of the level of the payer.

The recommendation only applies to the extent a taxpayer is actually entitled to a deduction for a payment under national law.[250] Accordingly, the rule will not apply to the extent the taxpayer is subject to entity-specific rules under the parent or payer jurisdiction that *de facto* prevent the payment from being deducted. This means that insofar the parent entity is, for instance, tax exempt under the laws of its own jurisdiction (or this entity is otherwise unable to claim deductions for any of its expenditure), no DD outcome arises.[251]

4.2.1.1 Primary Rule

The primary response is that the parent jurisdiction should implement a rule denying the deduction of a payment to the extent that it gives rise to a DD outcome.[252]

[247] *Ibid.* par. 319, p. 106
[248] In the BEPS Action 2 report, the meaning of a deductible payment covers any taxpayers' expenditures such as service payments, interest, rents, royalties and other amounts that may be set-off against ordinary income under the laws of the payer jurisdiction. Moreover, other deductible items may give rise to a DD outcome as well. Think in this respect of non-cash items such as depreciation. According to the OECD, states would complicate the implementation of its recommendations if they would distinguish between deductible payments and deductible costs not being attributable to a payment. See OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 188 and par 192, p. 69 – 70. See in this respect also par. 423 – 424.
[249] *Ibid.* par. 180(b), p. 68. See also par. 408, p. 128. For the purpose of this thesis, the terms *investor* and *parent* are considered to be equivalent. For the sake of consistency, the author will use the term *parent*.
[250] *Ibid.* par. 190, p. 70.
[251] *Ibid.* example 6.3, p. 320 – 325.
[252] *Ibid.* Recommendation 6.1, par. 186.

4.2.1.2 Secondary Rule

If the parent jurisdiction does not implement a rule denying deduction of the payment, the payer jurisdiction will deny the deduction for such payment to the extent that it gives rise to a DD outcome. The secondary rule, which imposes the same type of restriction in the payer jurisdiction, will only apply in the event that the effect of the mismatch is not neutralized in the parent jurisdiction.[253]

4.2.2 Hybrid Entity Mismatches with a D/NI Outcome

Recommendation 3 of BEPS Action 2 applies to a situation corresponding with the situation discussed under section 2.1.2, where a payment made leads to a D/NI outcome as the payment is deductible under the laws of the payer jurisdiction, while this is not recognized as such under the laws of the recipient jurisdiction,[254] given the hybrid character of the entity making the payment.[255] Recommendation 3 uses the terms payer jurisdiction and parent jurisdiction to distinguish between the places where the deduction arises respectively where the payment is received. The recommendation only applies to the extent that a taxpayer is actually entitled to a deduction for a payment under national law.[256] Accordingly, the rule will not apply to the extent the taxpayer is subject to entity-specific rules that *de facto* prevent the payment from being deducted.

4.2.2.1 Primary Rule

The primary response is that the payer jurisdiction should implement a rule denying the deduction of a disregarded payment[257] to the extent that it gives rise to a D/NI outcome.[258]

4.2.2.2 Secondary Rule

If the payer jurisdiction does not neutralize the mismatch, then the recipient jurisdiction will require such payment to be included in the ordinary income to the extent that the payment gives rise to a D/NI outcome.[259]

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[253] *Ibid.* par. 183, p. 68.
[254] The recipient jurisdiction includes any jurisdiction where the recipient is a taxpayer. A recipient means any person who receives a payment. The OECD uses the term "payee" which is, for the purpose of this thesis, considered to be analogue to the term "recipient". See OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 418 resp. 417.
[255] *Ibid.* par. 132, p. 53.
[256] *Ibid.* par. 122, p. 51.
[257] A disregarded payment is a payment that is not treated as a payment under the laws of the recipient jurisdiction or that is not otherwise taken into account as a receipt for tax purposes. See OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 133.
[258] *Ibid.* par. 116, p. 50.
[259] *Ibid.* par. 119, p. 50.

4.3 Recommendations Regarding Reverse Hybrid Entity Mismatches

4.3.1 Reverse Hybrid Entity Mismatches with a D/NI Outcome

Recommendation 4 of BEPS Action 2 applies to a situation corresponding with the situation discussed under section 2.2.1. In such an occasion, a payment is made to a reverse hybrid entity[260] results to a D/NI outcome. Indeed, the payment is deductible in the payer jurisdiction, yet, the payment received is not included in the ordinary income in the jurisdiction where this reverse hybrid *i.e.* the recipient is established (recipient jurisdiction), nor in the parent jurisdiction.[261] This is due to the fact that the reverse hybrid entity is treated as transparent under the law of the recipient jurisdiction, while, on the other hand, the reverse hybrid is treated as non-transparent in the parent jurisdiction. Recommendation 4 uses the terms payer jurisdiction, recipient jurisdiction, and parent jurisdiction to distinguish between the jurisdictions where the payment is made, where the payment is received and where the parent (investor) is established. The payer and recipient jurisdiction could be one and the same State, as shown in section 2.2.1.

4.3.1.1 Primary Rule

The recommended primary response under the reverse hybrid rule is to deny the deduction of the payment made to a reverse hybrid to the extent they give rise to a D/NI outcome.[262]

4.3.1.2 Secondary Rule

BEPS Action 2 does not provide for a secondary rule. BEPS Action 2 solely recommends the adoption of the primary response. However, BEPS Action 2 provides for specific recommendations for offshore investment regimes and encourages the establishment jurisdictions to turn off their tax transparency rules in those cases where an HMA occurs due to a reverse hybrid entity mismatch. The following section will elaborate on these two specific recommendations.

4.3.1.3 Specific Recommendations

BEPS Action 2 presents measures with regard to the tax treatment of transparent entities in recommendation 5.[263] As the OECD explicitly points out, this recommendation is not an HMA-rule.[264] Instead, the OECD sets out a recommendation covering the tax treatment of a payment made to a reverse hybrid under the laws of the parent and recipient jurisdiction in order to reduce the frequency of HMAs. First, the OECD focuses

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[260] The OECD defines a reverse hybrid as any person that is treated as transparent under the laws of the jurisdiction where it is established but as being a separate entity and thus being non-transparent by an investor in that reverse hybrid. See OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 140 see also recommendation 4.2, par. 157, p. 59.

[261] *Ibid.* par 139, p. 55.

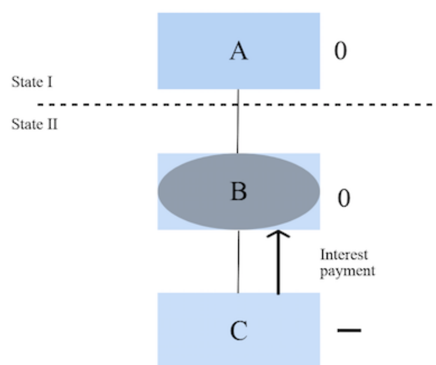
[262] *Ibid.* par. 142 and 144, p. 56.

[263] *Ibid.* p. 63 – 65.

[264] *Ibid.* par. 170, p. 64.

on improvements to Controlled Foreign Company-rules (CFC rules) and other offshore investment regimes under recommendation 5.1 of BEPS Action 2.

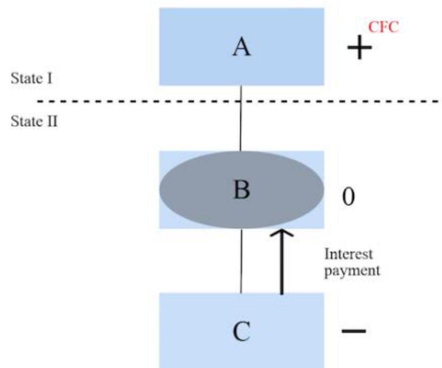
The OECD recognizes that groups can shift their profits to locations with a more favorable tax treatment, segregating the taxable income from its underlying activity in an artificial manner in order to pay fewer taxes.[265] CFC rules (and other anti-deferral rules) combat this phenomenon by enabling jurisdictions to tax income earned by foreign subsidiaries. A jurisdiction may use one or a combination of measures that could include CFC rules or other rules that tax a resident investor on changes in the market value of its subsidiary,[266] neutralizing any hybrid mismatch under a payment to a transparent entity.[267] It goes beyond the scope of this thesis to further elaborate on the mechanism of CFC rules or other anti-deferral rules.[268] However, it is relevant to remark that the payer jurisdiction could suspend the application of the primary rule in the case of the adoption of an offshore investment regime at the level of the parent jurisdiction. The following example illustrates the mechanism of CFC rules or other anti-deferral rules.



Suppose the situation corresponding to the situation as discussed in section 2.2.1, wherein entity C makes an interest payment to entity B. Entity B is considered as transparent from the perspective of State II, and, consequently, State II allocates the payment received to entity A, situated in State I. State I, however, considers entity B as being non-transparent. Hence, it does not recognize the payment as being received by entity A. Rather, it considers the payment as being received by entity B, situated in State II. Consequently, a deduction takes place at the level of entity C, without any corresponding inclusion of the payment made at the level of entity B nor entity A.

[265] OECD (2015). *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 11.
[266] OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 172, p. 64.
[267] *Ibid*. par. 173, p. 64.
[268] See for an in-depth discussion of CFC rules or another anti-deferral rule OECD (2015). *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

Now assume that State I adopts a CFC rule (or other anti-deferral rules) in its national legislation. This rule enables State I to tax income earned by foreign subsidiaries. In other words, entity A is obliged to consider the profits made by entity B, regardless of whether these profits have been distributed to A. In this manner, an HMA is neutralized, which eliminates the need for the adoption of the primary rule.



In addition to the specific recommendation regarding CFC rules for offshore investment regimes, the OECD encourages the recipient jurisdictions to turn off their tax transparency rules in those cases where an HMA occurs due to a reverse hybrid mismatch.[269] In other words, as recommendation 5.2 of BEPS Action 2 points out, the OECD suggests the State where the reverse hybrid entity is established should consider this entity as being non-transparent when the parent jurisdiction does so as well. The implementation of recommendation 5.2 will – likewise recommendation 5.1 – eliminate the need to apply the primary rule.

4.4 Recommendations Regarding Hybrid Financial Instrument Mismatches

4.4.1 Hybrid Financial Instrument Mismatches with a D/NI Outcome

Recommendation 1 of BEPS Action 2 applies to a situation corresponding with the situation discussed under section 2.3.1, where a payment made under a financial instrument results in a D/NI outcome. Such outcomes occur when a payment made is deductible in the payer jurisdiction, while the corresponding receivable is not (expect to be)[270] (fully) taxed in the recipient jurisdiction.[271] Recommendation 1 uses the terms payer jurisdiction and parent jurisdiction to distinguish between the places where the deduction arises respectively where the payment is received.

[269] OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 174 – 175, p. 64 – 65.
[270] *Ibid.* par. 29 and 33, p. 27 – 28.
[271] *Ibid.* par. 29, p. 27.

Given the wide variety of financial instruments and the different ways they can be characterized for tax purposes, the OECD considers it impossible to comprehensively and accurately identify all the situations where a payment under the instrument can give rise to an HMA.[272] Instead, the OECD focuses on (i) whether the payment is expected to give rise to a mismatch in tax outcomes, and (ii) whether that mismatch is attributable to the different treatment of the financial instrument under the respective laws of the payer and recipient jurisdictions. In accordance with the aforementioned recommendations of BEPS Action 2, recommendation 1 introduces a linking rule to ensure that the aggregate tax treatment of the arrangement is identical in both States involved, regardless the form of the financial instrument.

It should be noted that the OECD requires the financing arrangement to be treated as debt, equity or as a derivative contract under local law.[273] Moreover, in order to apply recommendation 1, the mismatch in tax treatment must be attributable to the terms of the instrument, rather than the status of the taxpayer or the context in which the instrument is held.[274] In other words, the application of recommendation 1 requires causality between the mismatch in tax outcomes and the terms of the underlying instrument.

4.4.1.1 Primary Rule

The primary response recommended in BEPS Action 2 is to align the tax treatment of the payments made under the arrangement so that the payer is not entitled to claim a deduction for the financing or equity return paid under the arrangement unless the payment is treated as ordinary income of the recipient.[275]

4.4.1.2 Secondary Rule

If the payer jurisdiction defaults on the primary rule, then the secondary rule comes into force at the level of the recipient jurisdiction, indicating that the payment received should be included in the ordinary income of the recipient.[276]

4.4.1.3 Specific Recommendations

Recommendation 2 of BEPS Action 2 targets recipient jurisdictions which contain a participation exemption (compare section 2.3.3) in its national legislation for dividend received. In this context, the OECD highlights the underlying purpose and objective of a dividend exemption, *i.e.* to avoid the imposition of an additional layer of taxation at the level of the recipient jurisdiction on income that has already been subject to tax at

[272] *Ibid*. par. 20, p. 25.
[273] *Ibid*. par. 19 and 27, p. 25 and 27.
[274] *Ibid*. par. 91 – 94, p. 41 – 42.
[275] *Ibid*. par. 21, p. 25.
[276] *Ibid*. par. 21, p. 25.

the level of payer jurisdiction.[277] With this in mind, recommendation 2 argues that jurisdictions providing the recipient with an exemption for dividends received should restrict that exemption to payments that have not borne tax at the level of the payer.

4.5 Recommendations Regarding Permanent Establishment Mismatches

4.5.1 Permanent Establishment Mismatches with a DD Outcome

Principally, HMAs that give rise to a DD outcome are addressed in the aforementioned recommendation 6 of BEPS Action 2. Although this recommendation is drafted broadly enough to cover DD outcomes arising due to branch structures, BEPS Action 2 does not consider (or at least not in detail) the application of the deductible hybrid payments rule to expenditures incurred through a branch.[278] Hence, as it is believed that PE mismatches should be addressed in more depth, the OECD introduced its Branch Report in addition to BEPS Action 2.[279] Recommendation 4 of the Branch Report clarifies the intended scope of recommendation 6 of BEPS Action 2, by restating and clarifying the operation of that rule in the context of PE structures.[280] For the purpose of this thesis, the Branch Report is considered to be part of BEPS Action 2.

Recommendation 4 of the Branch Report (as well as the other recommendations of the Branch Report) uses the terms residence jurisdiction and branch jurisdiction to distinguish between the jurisdiction in which the head office is established and the jurisdiction in which the branch is located. Recommendation 4 of the Branch Report supplements, and does not replace, recommendation 6 of BEPS Action 2, and covers situations corresponding with the situation discussed under section 2.4.1.

4.5.1.1 Primary Rule

The primary recommendation under the PE mismatch rule with a DD outcome is that the residence jurisdiction should restrict the deductibility of any payment, expense or loss that is also deductible under the laws of the branch jurisdiction.[281]

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[277] *Ibid.* par. 106, p. 46. This objective is also recognized by the Dutch Supreme Court. See in this respect Supreme Court 11 April 2001, no. 35 729, *BNB* 2001/257c.
[278] OECD (2017), *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 86, p. 44.
[279] OECD (2017), *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
[280] *Ibid.* par. 87, p. 44.
[281] *Ibid.* par. 88, p. 44.

4.5.1.2 Secondary Rule

The secondary rule imposes the same type of restriction in the branch jurisdiction.[282] The secondary rule only applies in the event that the effect of the mismatch is not neutralized in the residence jurisdiction.

4.5.2 Permanent Establishment Mismatches with a D/NI Outcome

A deductible payment will give rise to a D/NI outcome where that payment is not included in the ordinary income by the residence nor branch jurisdiction.[283] Recommendation 2 of the Branch Report is analogous to the reverse hybrid rule as set out under recommendation 4 in BEPS Action 2, and distinguishes between *diverted PE payments* and *disregarded PE structures*.[284] A mismatch due to a diverted PE payment arises due to the differences between the laws of two jurisdictions as to the attribution of payments to the PE.[285] The branch jurisdiction considers the payment (from a third entity or branch) as being made directly to the entity (*i.e.* head office) in the residence jurisdiction, while the latter jurisdiction allocates the payment to the PE. As a result, neither the branch jurisdiction nor the residence jurisdiction includes the payment in its taxable base, while the payment made is deductible at the level of the third entity or branch.

In a disregarded PE structure, a D/NI outcome arises due to the fact that a payment received by an entity is treated as being made to the PE under the laws of the residence jurisdiction, while the branch jurisdiction does not recognize the existence of the PE, and therefore does not recognizes the payment received.[286]

Recommendation 3 of the Branch Report deals with a *deemed PE payment*, which is a payment made between the PE and the head office (or between two PEs of the same entity, which will be disregarded in this thesis for feasibility reasons), and corresponds with the situation discussed under section 2.4.2.

As a quick refresher, suppose that a PE is in place from the perspective of the branch jurisdiction. However, the residence jurisdiction does not recognize a PE in the branch jurisdiction. Suppose now that a payment is made from the PE to the head office. This payment is now deductible from the taxable base in the jurisdiction in which the PE is situated. Yet, it is not included in the taxable base in the resident jurisdiction, because the latter jurisdiction does not recognize the PE, and hence does not recognize the payment as well. A payment made is now deducted in the branch jurisdiction, while the subsequent receivables are not recognized in the residence jurisdiction.

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[282] *Ibid.* par. 88, p. 44.
[283] *Ibid.* par. 41, p. 28.
[284] *Ibid.* par. 42, p. 28.
[285] *Ibid.* par. 42(a), p. 28.
[286] *Ibid.* par. 42(b), p. 28.

4.5.2.1 Primary Rule

Recommendation 2 of the Branch Report brings the treatment of both a diverted PE payment as well as disregarded PE structures in line with the outcomes of recommendation 4 of BEPS Action 2. Hence, it denies the deduction for payments to the extent that the allocation of payments between the two jurisdictions gives rise to a mismatch in tax outcomes.

Recommendation 3 intents to bring the treatment of deemed PE payments into line with the rules that apply under recommendation 3 of BEPS Action 2,[287] and requires the payer jurisdiction to deny a deduction for a deemed payment to the extent it gives rise to a D/NI outcome.[288]

4.5.2.2 Secondary Rule

Recommendation 2 of the Branch report restate and clarify the operation of the reverse hybrid rule. Therefore, corresponding to the reverse hybrid rule, recommendation 2 of the Branch report does not provide for a secondary rule. Recommendation 3 of the Branch Report does not provide for a secondary rule as well. Both recommendations justify the absence of a secondary rule by referring to the following specific recommendation.

4.5.2.3 Specific Recommendations

In recommendation 1.1 of the Branch Report, the OECD states that PE mismatches with a D/NI outcome most frequently arise where the net income of the branch is exempt from taxation in the residence jurisdiction.[289] These mismatches can be significantly reduced if the residence jurisdiction modifies the operation of its PE exemption so as to ensure that the net income eligible for exemption is not higher than the income actually included in the branch jurisdiction. According to the OECD, this can be achieved by including any item of income that is not taxed by the branch jurisdiction, "*by making the necessary adjustments to take into account the effect of deemed payments made from the branch to the head office*."[290] The OECD, therefore, recommends that jurisdictions to consider modifying the scope and operation of their PE exemption regime in order to (i) consider payments that are not included in the income of a branch and (ii) include deemed payments made by a branch.

As with recommendation 5 of BEPS Action 2, recommendation 1 of the Branch Report is designed to ensure that the PE exemption operates in line with the intended tax policy settings in the residence jurisdiction in

[287] *Ibid.* par. 62, p. 62.
[288] *Ibid.* par. 65, p. 65.
[289] *Ibid.* par. 32, p. 24.
[290] *Ibid.* par. 32, p. 24.

respect of the taxation of worldwide income, while preserving the ability of jurisdictions to determine the scope of their taxing jurisdiction consistent with their general system of taxation.[291] Corresponding the aim of recommendation 5 of BEPS Action 2, recommendation 1 has the purpose to reduce the frequency of PE mismatches. The recommendation in itself is, therefore, no PE mismatch rule.[292] As with recommendation 5 of BEPS Action 2, there are a number of ways the residence jurisdiction could make an adjustment to include an appropriate amount of additional income under the laws of the residence jurisdiction in order to neutralize any double non-taxation outcome and, accordingly, recommendation 1.1 does not extend to describe the way in which the payment of untaxed PE income may be taken into account in the head office.

4.6 Recommendations Regarding Tax Residency Mismatches

4.6.1 Tax Residency Mismatches with a DD Outcome

Recommendation 7 of BEPS Action 2 applies to a situation corresponding with the situation discussed under section 2.5.1, where a payment made by a dual resident taxpayer will trigger a DD outcome as the payment is deductible under the laws of both jurisdictions where the taxpayer is resident.[293] Such a DD outcome only arises when one jurisdiction permits that deduction to be set-off against an amount that is not treated as income under the laws of the other jurisdiction.

4.6.1.1 Primary Rule

According to the OECD, a distinction between the parent and payer jurisdiction as made under recommendation 6 is not possible in the context of dual resident taxpayers. Indeed, it might be difficult, if not impossible to reliably distinguish between the place where the payment is actually made and the place where the duplicate deduction arises.[294] Therefore, the OECD recommendation suggests that both jurisdictions simultaneously apply the primary rule to restrict the deduction to dual inclusion income.[295] Obviously, having both States apply the same rule to the same payment raises the risk of double taxation. However, without going into detail, the OECD states that structuring alternatives are usually available which can prevent double taxation from arising.[296]

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[291] *Ibid.* par. 36, p. 25.
[292] *Ibid.* par. 37, p. 25.
[293] OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, par. 216, p. 77. A person should be treated as a resident of a jurisdiction for tax purposes if it qualifies as tax resident or is taxable in that jurisdiction on their worldwide net income. See in this respect par. 231, p. 80.
[294] *Ibid*. par. 217, p. 78.
[295] *Ibid*. par. 227, p. 80.
[296] *Ibid*. See example 7.1, par. 5, p. 337.

4.6.1.2 Secondary Rule

BEPS Action 2 does not provide for a secondary rule. Given the nature of the primary rule, providing that both jurisdictions involved should react correspondingly, a secondary rule is considered to be otiose.

4.7 Some Political Thoughts about BEPS Action 2

Already in its letter of 17 January 2013,[297] the Netherlands recognizes BEPS as an important issue, and acknowledges the role that MNEs situated in the Netherlands play in base eroding structures. In this light, the Netherlands commits itself to adjust its national legislation in order to better align the Dutch tax system with foreign tax systems. For instance, the Netherlands took over the four minimum standards – agreed upon by the OECD in its BEPS Project – into its national legislation. These minimum standards encompass the exchange of information on rulings, country-by-country reporting, improving dispute resolutions, and combating treaty abuse.

A number of measures proposed in the OECD BEPS Project, however, have not led to the amendment of the Dutch tax system. This is because it is believed that unilateral actions by the Netherlands would not resolve the underlying issues, and could moreover inadmissibly damage the Dutch investment climate. The Netherlands considers measures towards greater coherence to be effective only when they are taken on a multilateral and binding basis.[298] Measures against HMAs will therefore only be implemented in the Dutch tax system under a binding international obligation – such as the ATAD – that guarantees the level playing field between the Member States. Hence, the Netherlands' tax law has not been changed due to BEPS Action 2. See in this respect the following letter of the (former) Dutch State Secretary of Finance:

"*…The Netherlands endorses the idea that HMAs must be tackled. However, given the complexity of the problem, the rules of BEPS Action 2 are considered to be complicated to implement and execute. Moreover, HMAs can only be neutralized when all States consistently implement the results of BEPS Action 2. If one or more States do not implement the outcomes of BEPS Action 2, it is inevitable that MNEs move their business activities to States where it is still possible to enter into an HMA. For this reason, the Netherlands considers a coordinated approach, for example within the EU, to be of great importance. The Netherlands strongly recommends that BEPS Action 2 will be laid down in a binding treaty for all EU Member States…*"[299]

[297] Documents of the Second Chamber of Parliament, 2012-2013, 25087, no. 34.
[298] Documents of the First Chamber of Parliament, 2015, no. IZV/2015/657M.
[299] Letter from the State Secretary of Finance, presenting an assessment of the outcome of the BEPS Project and the outlook for the Dutch tax climate for businesses. 5 October 2015, no. IZV/2015/657M.

4.8 BEPS Action 2 in the Light of the Concept of Source Country Entitlement

4.8.1 The Primary and Secondary Rules

As been observed, the OECD proposes a linking rule for each mismatch outcome. In all cases, there is a primary rule that must be invoked. When an HMA occurs due to (i) payments made by a hybrid entity; (ii) payments made via a hybrid financial instrument; or (iii) PE qualification conflicts with a DD outcome, there is a secondary rule in place. The secondary rule is, however, disregarded if the primary rule is applied but comes into force when the primary rule is not invoked by the other State involved.

Given this approach, it does not seem to matter where taxation actually takes place. Instead, the OECD recommendations appear to be designed to ensure that income arising under HMAs is taxed in at least one State, and expenses incurred by MNEs are deducted only in one State, irrespective of whether value is actually created in the State where taxation takes place.

The ostensible lack of an overarching principle is even more distressing. Indeed, the coordination of BEPS Action 2 does not appear to be based on any international allocation principle for corporate income. Even if one can find legal justification grounds for the allocation of taxing rights, the OECD is at least not consistent in the application of it. Moreover, whether the tax is collected under the primary rule or defensive rule seems to be immaterial, and BEPS Action 2 deliberately avoids any attempt to determine which State has lost revenue and which State should benefit from a greater revenue collection.[300]

This is remarkable, and counters the original policy underlying to the OECD BEPS Project, where "*profits are taxed where the economic activities generating the profits are performed and where value is created.*"[301] Instead, BEPS Action 2 pursuits that all profits should be taxed at least once, irrespective of where the value is created. This is even more perceptible in the BEPS Action 2 recommendations with regard to tax residency mismatches, where both jurisdictions involved should simultaneously deny deduction, which inevitably leads to double taxation.

In the light of the aforementioned, a more accurate starting point would be that profits should be relocated to the other State, insofar the economic activities generating the profits are not taxed where these activities are performed, and where value is created. This is also noted by Cooper, who aptly note that "*it does seem*

[300] See OECD (2014). *Public Discussion Draft. BEPS Action 2: Neutralize the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)*, par. 28, p. 10, which states that "*The Action Plan simply calls for the elimination of the DD and D/NI outcomes without requiring the jurisdiction applying the rule to establish that it has 'lost' tax revenue under the arrangement.*"

[301] See OECD (2015). *Explanatory Statement,* OECD/G20 Base Erosion and Profit Shifting Project, p. 4; and OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 3.

more than a little odd to say that states should agree to a rule for no reason other than this imposes tax on someone somewhere."[302] Obviously, when the OECD recommendations as such are pursued and implemented, a State's tax system will become structurally dependent on the policies and practices of the other jurisdiction, and governments will have to accept a constraint on their tax autonomy.

4.8.2 The Specific Recommendations

In respect to payments made to a reverse hybrid payer, under a hybrid financial instrument, and under a PE mismatch with a D/NI outcome, the OECD recommends specific changes to domestic law (see respectively section 4.3.1.3, section 4.4.1.3, and section 4.5.2.3). The assumption behind the recommended changes to domestic law is that these amendments make HMAs less likely to occur. Although these recommendations most likely contribute to the reduction of the amount of HMAs, these recommendations do not (or at least not by definition) seem to uphold the concept of source country entitlement.

It goes beyond the scope of this chapter to actually assess the BEPS Action 2 recommendations against the concept of source country entitlement. Nevertheless, the author considers it to be relevant to illustrate how the BEPS Action 2 recommendations could contravene with this concept, all the more because these specific recommendations are not per se reflected in *Chapter 5*, wherein this assessment does take place. For this reason, the author briefly considers the specific recommendations in the light of the guiding principle of the OECD BEPS Project. The following examples will – as a sneak peek of *Chapter 5* – endorse the fact that the BEPS Action 2 recommendations do not necessarily pursue the concept of source country entitlement.

4.8.2.1 Recommendation 5.1 of BEPS Action 2: CFC Rules and Other Offshore Investment Regimes

Without discussing CFC rules and other offshore investment regimes into detail, consider an MNE with a parent entity in the Netherlands, and a subsidiary in Bulgaria. The subsidiary conducts business activities generating profit within the territory of Bulgaria. Now assume that the subsidiary in Bulgaria is considered to be a reverse hybrid entity. Suppose furthermore that a CFC regime is applicable in this situation since Bulgaria has a relatively low CIT rate compared to the Netherlands. The profits generated in Bulgaria are now (partly) to be taxed in the Netherlands. Does this approach really comply with the concept of source country entitlement?

4.8.2.2 Recommendation 2 of BEPS Action 2: Denial of Participation Exemption

[302] Cooper, G. S. (2015). *Some Thoughts on the OECD's Recommendations on Hybrid Mismatches*. Bulletin for International Taxation, 69(6/7), par. 3.2.4, p. 345.

Assume again that an MNE has a parent entity in the Netherlands, which, on its turn, holds a subsidiary in Germany. The parent entity grants a loan to the subsidiary under favorable conditions, not corresponding with the interest rate on the capital market in the favor of the subsidiary. The subsidiary makes an interest payment to the parent entity, which is considered as a tax-deductible business expense in Germany. However, from a Dutch perspective, given the favorable conditions of the loan, the payment received is considered to be a tax-exempt dividend distribution on the grounds of the Dutch participation exemption. Yet, the OECD states that the Netherlands should restrict that exemption, since to payment has not borne tax at the level of the subsidiary. Indeed, the occurrence of an HMA is neutralized, but again, does such an approach really reflects the concept of source country entitlement?

4.8.2.3 Recommendation 5.1 of the Branch Report: Denial of Object Exemption

Now assume again that an MNE has a parent entity in the Netherlands. This MNE has – corresponding the upper examples – an economic allegiance in both Bulgaria and Germany. This economic allegiance is exerted via a subsidiary in Bulgaria, and via a branch in Germany. The business activities in Germany are very profitable, leading to a high amount of excess cash. The branch in Germany grants a loan to the subsidiary in Bulgaria, and receives interest payments in return. Germany does not classify the branch as a PE. Hence, from the perspective of Germany, the interest payments are considered to be received by the Netherlands. The Netherlands, however, does recognize a PE in Germany, and considers the payment as to be made to this PE. Consequently, an HMA is in place, as the interest payment is deducted in Bulgaria, but not included in Germany nor the Netherlands. The OECD states that the Netherlands should make the necessary adjustments to consider interest received by the branch in Germany. Once more, is this approach really in line with the concept of source country entitlement?

4.9 Conclusion; All Profits should be Taxed at least Once

In this chapter, an overview of the technical aspects of BEPS Action 2 has been provided. It has been shown that BEPS Action 2 aims to neutralize HMAs between related parties and entities within the same control group, regardless of the parties’ intentions.

The OECD proposes a linking rule for each mismatch outcome. In all cases, there is a primary rule that must be invoked. In some cases, there is a secondary rule in place. The secondary comes into force only if the primary rule in the other State is not invoked. With this in mind, the OECD recommendations seem somewhat arbitrary, and appear to be designed to ensure that income arising under HMAs is taxed in at least one State, and expenses incurred by MNEs are deducted only in one State. It does not seem to matter in which jurisdiction taxation actually takes place.

BEPS Action 2 deliberately avoids any attempt to neutralize HMAs via a supranational instrument. Instead, a series of domestic rules are proposed. In the author's view, it is far from obvious that this is a suitable way to approach the topic. The Netherlands firmly stated that the BEPS Action 2 recommendations are considered to be effective only when they are taken on a multilateral and binding basis. The author tends to agree on this view and considers the Netherlands' refusal of the implementation of BEPS Action 2 in its national legislation as appropriate, given the non-binding character of its recommendations. If one or more States do not implement the outcomes of BEPS Action 2, it seems to be inevitable that MNEs move their business activities to States where it is still possible to enter into an HMA.

Maybe even more distressing is the fact that the proposed recommendations do not need to be harmonized around any substantive doctrine or concept for the international allocation of corporate income. As been shown under section 3.1.1 and section 3.1.2, taxation should be perceived as a contribution which flows from the relationship between a State and an individual, and a State's tax claim is legitimate or can be justified only in those cases in which taxes are understood as a consideration for benefits provided to the individual through State activities. Nonetheless, BEPS Action 2 does not bother to determine which State has lost revenue, and which State should benefit by a greater revenue collection. Any rule that reverses the effect of the HMA seems to be acceptable, and the recommended solutions are entirely agnostic as to which State should collect the revenue.

5. HMAs in the Internal Market; the Anti-Tax Avoidance Directive

In January 2016, the EC presented its proposal for an ATAD as part of the Anti-Tax Avoidance Package.[303] The European Council adopted the ATAD in June 2016, under which a provision had been introduced against HMAs.[304] This provision covered situations concerning hybrid entities and hybrid financial instruments with a DD outcome or a D/NI outcome.[305] Yet, the initial version of the ATAD was limited to intra-EU situations, and taxpayers engaged in cross-border structures involving third States (*i.e.* non-EU States) could still take advantages of HMAs, reducing their overall tax liability within the EU.[306] Moreover, other types of HMAs, such as hybrid permanent establishment mismatches and dual resident mismatches, were not addressed in the initial ATAD.

For this reason, the finance ministers from all Member States (ECOFIN Council) issued a statement in July 2016, requesting the EC to put forward a proposal on HMAs involving third States.[307] This proposal was presented in October of the same year and approved by the European Council in May 2017. The scope of the ATAD is not just extended in a geographical sense, but does also address a wider variety of HMAs "*in order to provide for rules consistent with and no less effective than the rules recommended by the OECD BEPS Report on Action 2*."[308] The provisions in the ATAD must be applied from 1 January 2020, with a derogation being permitted for the reverse hybrid mismatch rule, which applies from 1 January 2022.

At first sight, the ATAD reads as a technically complex form of legislation. Similar to BEPS Action 2, one has to scrutinize different components of the ATAD to get a better understanding of its provisions. For instance, given the absence of a continuous legislation of the ATAD as a whole, one has to consider both directives before and after its amendment (generally referred to ATAD 1 and ATAD 2 respectively) to get a clear picture of the chronology. Moreover, it is not exceptional that the preamble of both the ATAD 1 or ATAD 2 has to be consulted in order to contextualize the ATAD provisions.

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[303] EC (2016). Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (EU) 2016/0011.

[304] Article 9 ATAD 1.

[305] It became apparent since the Columbus Container Service ruling that a directive is the designated instrument to eliminate HMAs, since any obstacle arising of the autonomous application of the tax classification methods are due to disparities which are beyond the scope of the fundamental rights and freedom of the EU. See CJEU 6 December 2007, Case C-298/05, *Columbus Container Services BVBA & Co. v. Finanzamt Bielefeld-Innenstadt*.

[306] See the explanatory memorandum of EC (2016). *Proposal for a Council Directive Amending Directive as regards hybrid mismatches with third countries*, (EU) 2016/0339.

[307] EC (2016). *Proposal for a Council Directive Amending Directive as regards hybrid mismatches with third countries*, (EU) 2016/1164, par. 5, p. 3.

[308] See the explanatory memorandum of EC (2016). *Proposal for a Council Directive Amending Directive as regards hybrid mismatches with third countries*, (EU) 2016/0339. See in this respect also EC (2016). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164, preamble 27, where we read that "*[by] implementing this Directive, Member States should use the applicable explanations and examples in the OECD report on (...) Action 2 (...) as a source of illustration or interpretation to the extent that they are consistent with the provisions of this Directive and with Union law*.

Given the fact that ATAD 1 and ATAD 2 are being inextricably linked, the author prefers to move away from its conventional distinction. For the sake of clarity, the terms ATAD 1 and ATAD 2 will be disregarded in this thesis, and, from now on, any reference made to the ATAD refers to the aggregation of both the ATAD 1 and ATAD 2.

This chapter presents the technical delimitation of the ATAD under section 5.1. Hereinafter, attention will turn to the ATAD provisions against HMAs. In section 5.2, the ATAD measures regarding hybrid entities will be covered. Section 5.3 covers the ATAD measures with respect to reverse hybrid entities. Section 5.4 provides for the ATAD measures against hybrid financial instruments. Section 5.5 and section 5.6 will eventually discuss the ATAD measures regarding PE mismatches and tax residency mismatches respectively. Section 5.7 provides for conclusions and, where applicable, for recommendations with regard to an alternative approach. This chapter was referred to as the *contemplative* aspect of this thesis in *Chapter 1*. Every ATAD measure will be analyzed in a threefold manner:

(i) The applicable ATAD provision will be verified in the light of BEPS Action 2.

(ii) The HMA that the ATAD provision pursues to combat will be outlined in a presumed case in the context of the Netherlands.

(iii) The enactment of the applicable ATAD measure will be considered in the light of the under *Chapter 3* developed benchmark, with emphasis on the concept of source country entitlement.

5.1 The Delimitation of the ATAD

The author distinguishes three elements with regard to the scope of the ATAD; a *geographical* element, an *objective* element, and a *subjective* element. The geographical element of the ATAD determines its territorial scope. The objective element of the ATAD determines the types of mismatches that are covered by the ATAD. The subjective element of the ATAD rules the extent to which its provisions are applicable, *i.e.* when does a person fall within the scope of the ATAD? These elements will be discussed in more depth in the subsequent sections.

5.1.1 The Geographical Scope of the ATAD

The ATAD is geographically delineated to taxpayers that are subject to CIT in one or more Member States, with the inclusion of PEs situated in a Member State.[309] In other words, only non-transparent entities[310] and PEs within the territorial jurisdiction of the EU fall within the scope of the ATAD. Hence, reverse hybrid entities would, in principle, fall outside the scope of the ATAD, as they are considered to be transparent from the perspective of the State of residence (compare section 2.2). Indeed, given its nature, a reverse hybrid entity is not subject to CIT in the Member State where it is situated. In order to bring a reverse hybrid entity situated in a Member State within the scope of the ATAD, an additional provision has been introduced which now includes transparent entities insofar a reverse hybrid mismatch is in place.[311] For this reason, the Netherlands will extend the subjective scope of the CITA to entities situated in or registered by the Netherlands, or incorporated under Dutch law if this entity is considered to be a reverse hybrid entity.[312]

5.1.2 The Objective Scope of the ATAD

Within the ATAD, the recognition of HMAs is considered to be roughly in line with BEPS Action 2. The ATAD considers an HMA to be in place when there is a situation involving a taxpayer or an entity where:[313]

a. a payment under a financial instrument gives rise to a D/NI outcome (compare section 4.4.1 for its BEPS Action 2 counterpart);[314]

b. a payment to a hybrid entity gives rise to a D/NI outcome, and that mismatch outcome is the result of differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction where the hybrid entity is established or registered and the jurisdiction of any person with a participation in that hybrid entity (reverse hybrid entity mismatch, compare section 4.3.1 for its BEPS Action 2 counterpart);[315]

c. a payment to an entity with one or more PEs gives rise to a D/NI outcome, and that mismatch outcome is the result of differences in the allocation of payments between the head office and PE or between two or more PEs of the same entity under the laws of the jurisdictions where the entity operates (compare section 4.5.2 for its BEPS Action 2 counterpart);[316]

[309] EC (2016). *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market* (EU) 2016/1164, Article 1.
[310] With reference to section 2.1.3 of this thesis, entities are subject to CIT only when they are considered to be non-transparent from the perspective of the State of residence.
[311] EC (2016). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164. Article 1 amends the scope of the ATAD by stating that "*Article 9a also applies to all entities that are treated as transparent for tax purposes by a Member State.*"
[312] Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 1.
[313] EC (2016). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164. Article 1, par. 2(b) amends the definition of hybrid mismatches, embedded in Article 2, par. 9 of the ATAD."
[314] Article 2, par. 9(a) ATAD.
[315] Article 2, par. 9(b) ATAD.
[316] Article 2, par. 9(c) ATAD.

d. a payment gives rise to a D/NI outcome as a result of a payment to a disregarded PE (compare again section 4.5.2 for its BEPS Action 2 counterpart);[317]

e. a payment by a hybrid entity gives rise to a D/NI outcome and that mismatch is the result of the fact that the payment is disregarded under the laws of the recipient jurisdiction (hybrid entity mismatch, compare section 4.2.2 for its BEPS Action 2 counterpart);[318]

f. a deemed payment to the head office and PE or between two or more PEs gives rise to a D/NI outcome and that mismatch is the result of the fact that the payment is disregarded under the laws of the recipient jurisdiction (compare section 4.5.2 for its BEPS Action 2 counterpart);[319] or

g. a DD outcome occurs (compare section 4.2.1 and section 4.5.1 for its BEPS Action 2 counterparts).[320]

The objective scope of the anti-HMA measures under Dutch tax law will be codified accordingly under Article 12aa, paragraph 1 of the CITA 1969.[321]

5.1.2.1 Special Provisions

Based on the abovementioned examples, all HMAs identified under *Chapter 4* seem to be covered under the work of the ATAD. Yet, it was deemed to be necessary to address reverse hybrid entities (compare section 4.3.1.3 for its BEPS Action 2 counterpart)[322] as well as tax residency mismatches (compare section 4.6.1 for its BEPS Action 2 counterpart)[323] in a separate article. It will be examined in section 5.3 and section 5.6 respectively what the rationale behind these provisions is.

5.1.2.2 The Absence of Carve-Out for Non-Abuse

Evidently, HMAs are often used as a result of a desire to implement aggressive tax planning schemes. Yet, this does not mean that HMAs are inevitably the product of such aggressive tax planning schemes. In some cases, there might be entirely non-tax drivers to the use of such arrangements.[324] It is recognized by the author that the incidence of such cases may be debated. However, whilst the ATAD recognizes that HMAs are often the product of aggressive tax avoidance, it then proceeds as if this is always the case. The ATAD measure is corresponding to BEPS Action 2 (compare section 4.2.1) mechanical in its nature; the intention

[317] Article 2, par. 9(d) ATAD.
[318] Article 2, par. 9(e) ATAD.
[319] Article 2, par. 9(f) ATAD.
[320] Article 2, par. 9(g) ATAD.
[321] Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 35 – 48.
[322] Article 9a ATAD.
[323] Article 9b ATAD.
[324] Collier, R., Kari, S., Ropponen, O., Simmler, M., & Todtenhaup, M. (2018). *Dissecting the EU's Recent Anti-Tax Avoidance Measures: Merits and Problems* (No. 8). Institute-Leibniz Institute for Economic Research at the University of Munich, par. 3.1.4, p. 14.

or a motive is not relevant for the application of the ATAD. This is also remarked in the Dutch legislative proposal.[325]

5.1.3 The Subjective Scope of the ATAD

For the purpose of the ATAD, the abovementioned HMAs[326] are only to be taken into consideration when the mismatch arises between *associated enterprises*, between a taxpayer and an associated enterprise, between the head office and the PE, between two or more PEs of the same entity, or under a *structured arrangement*.[327] This delimitation seems, in first glance, to link up with the BEPS Action 2 recommendations. Both terms will be elaborated upon in the following subsections.

5.1.3.1 Associated Enterprises

The term *associated enterprise* principally covered any entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25 percent or more, or is entitled to receive 25 percent or more of the profits of that entity.[328] An associated enterprise was also considered to be in place in the opposite situation, *i.e.* where an entity holds a direct or indirect participation of 25 percent or more of the profits of the taxpayer.[329] Yet, under the amended ATAD, it is decided to modify the 25 percent standard to 50 percent for HMAs that find their cause in the hybrid nature of an entity, as it is believed that these HMAs should be addressed only where one of the associated enterprises has effective control over the other associated enterprise.[330] Consequently, it is now required that an associated enterprise is held by, or holds, the taxpayer or another associated enterprise through a participation of no less than 50 percent.[331] The ownership or rights of persons[332] who are acting together, should be aggregated.[333] Under the ATAD, the initial 25 percent threshold does now only apply to hybrid financial instruments.[334] The

[325] Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 10.
[326] The ATAD uses the term *hybrid mismatches*. For the sake of consistency, it has the preference to refer to hybrid mismatch arrangements (HMAs).
[327] EC (2016). *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market* (EU) 2016/1164, Article 1, par. 2(b) amends Article 2, par. 9.
[328] EC (2016). *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market* (EU) 2016/1164, Article 1, par. 2(a) amends Article 2, par. 4(a).
[329] EC (2016). *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market* (EU) 2016/1164, Article 1, par. 2(a) amends Article 2, par. 4(b).
[330] EC (2016). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164, par. 13 of the preamble.
[331] *Ibid.*
[332] A person means an individual or entity. See EC (2016). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164. Article 1 clarifies the term *persons* by modifying Article 2, par. 9 under h.
[333] EC (2016). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164. Article 1 enhances the term *associated enterprise* by modifying Article 2, par. 4. Article 2, par. 4(b) states that "*a person who acts together with another person in respect of the voting rights or capital ownership of an entity 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.*"
[334] EC (2016). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164. Article 1 enhances the term *associated enterprise* by modifying Article 2, par. 4. Article 2, par. 4(a) states that "*where the mismatch outcome arises under point (b) [reverse hybrid entity mismatch], (c) [PE mismatch], (d) [PE mismatch}, (e) [hybrid entity mismatch], or (g) [every mismatch with a DD outcome], of the first subparagraph of point (9) of this Article [Article 1] or where an adjustment is required under Article 9, par. 3 [imported mismatches] or Article 9a [lex specialis reverse hybrid mismatch], the definition of associated enterprise is modified so that the 25 percent requirement is replaced by a 50 percent requirement.*"

Netherlands, however, dovetails with the initial version of the ATAD, and considers an affiliation to be qualified as associated enterprises if the taxpayer directly or indirectly holds a participation of 25 percent or more in another entity, regardless of the type of HMA.[335] Simplicity and consistency reasons are the stated arguments in this respect.

The subjective scope of the anti-HMA measures with respect to associated enterprises under Dutch tax law will be codified accordingly under Article 12aa, paragraph 2(a) in conjunction of Article 12ac, paragraph 2 of the CITA 1969.[336]

As from the introduction of the amended ATAD, an associated enterprise also comprises any entity that is part of the same consolidated group for financial accounting purposes as the taxpayer.[337] This is the case when both entities are included in the consolidated financial statements, drawn up in accordance with IFRS or the national financial reporting system of a Member State.[338] An associated enterprise also includes an enterprise in which the taxpayer has a significant influence in the management or an enterprise that has a significant influence in the management of the taxpayer.[339]

5.1.3.2 Associated Enterprises in the Absence of a Majority of the Shares?

The question raises how the *significant influence-criteria* relates to the *50 percent-criteria*. Given the fact that one can exert significant influence with less than 50 percent of the ownership, it is conceivable that the upward adjustment from 25 percent to 50 percent can be overruled by the significant influence-criteria.[340] For instance, a participant holding 20 percent of the shares in an entity is still likely to have significant influence in this entity when the remaining shares are divided over thousands of participants, holding no more than 0,01 percent per participant. One could question whether the 20 percent shareholder is subject to the ATAD in this respect.

5.1.3.3 Structured Arrangement

The amended ATAD states that "*a structured arrangement should be interpret as an arrangement involving an HMA, where the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce an HMA, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the HMA, and did not share in the value of the tax benefit resulting from*

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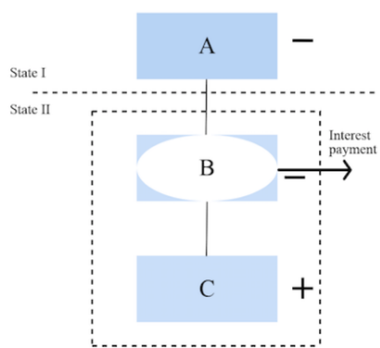
[335] Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 10.
[336] See in this respect also Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 62.
[337] EC (2016). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164. Article 2, par. 4(c).
[338] *Ibid*. Article 2, par. 10.
[339] *Ibid*. Article 2, par. 4. See also par. 13 of the preamble.
[340] Vakstudie Nieuws (2017). *Antibelastingontwijkingsrichtlijn 2 (ATAD 2)*, V-N 2017/36.3, p. 7.

the HMA."[341] Although the ATAD does not further elaborate on this term, it is obvious that it aims to counter HMAs between associated enterprises, making use of an independent third party as a middleman. In this light, the approach under the ATAD corresponds with the *structured arrangement-criteria* of BEPS Action 2 (compare section 4.1.2). The structured arrangement-criteria shall be codified accordingly under Dutch legislation.[342]

5.2 Measures Against Hybrid Entity Mismatches

5.2.1 Hybrid Entity Mismatches with a DD Outcome

State I considers entity B to be transparent, resulting in an interest deduction when determining the profits of entity A. From the perspective of State II, however, entity B is considered to be non-transparent. Entity B can enter into a tax group regime with entity C and, consequently, the interest can be deducted from the tax group profits as well. This structure is referred to as an HMA with a DD outcome under Article 2, paragraph 9(g) of the ATAD.



5.2.1.1 Proposed Solution under the ATAD

In intra-EU situations, the ATAD requires that, when a DD outcome is in place, the deduction shall be granted only in the payer jurisdiction.[343] To the extent that an HMA with a DD outcome involves a third State, the Member State concerned shall deny the deduction of a DD payment (even if the payment made has its source in that Member State) unless the third State has already done so.[344]

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[341] EC (2016). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164. Article 1 clarifies the term *structured arrangement* by introducing Article 2, par. 10.
[342] Compare the newly introduced Article 12aa, par. 2(d), Article 12ab, par. 1, Article 12ad, par. 1, and its definition under Article 12ac, par. 1(f). See in this respect also the explanatory memorandum of the Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 10 and p. 59 – 60.
[343] Article 9, par. 1(a) ATAD.
[344] Article 9, par. 1(b) ATAD.

5.2.1.2 Obscure Terminology?

The purport of this provision appears to be in line with the purpose and intent of the BEPS Action 2 recommendation (compare section 4.2.1). However, in their evaluation on the ATAD after its amendment, Stevens and Fibbe note that by means of the wording of the ATAD provision, both Member States involved may argue that the opposite Member State should deny deduction, as both Member States could claim that the payment made has its source within its own jurisdiction.[345] Indeed, given the aforementioned example, State I considers entity A to have a participation in entity C (since entity B is considered to be a transparent entity), and recognizes a debt to a third party at the level of entity A. For this reason, State I might claim that the source of the interest payment is in State I. State II, on the contrast, could argue from that same line of reasoning. Entity B is considered to be non-transparent in State II, and the debt is considered as being due at the level of entity B. The interest payment, from the perspective of State II, has its source in State II. Stevens and Fibbe argue that, due to its obscure terminology, inconsistencies could arise when implementing the ATAD.

Both scholars have a valid point with respect to the ATAD before its amendment. However, they ignore that fact that, after its amendment, the ATAD uses a different phrasing in its DD provision. In its pre-amended version, the ATAD considers a DD outcome to be in place when *"a deduction of the same payment, expenses, or losses from the taxable base occurs both in the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered, and in the other jurisdiction."*[346] It then states that "*to the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source."*[347]

After its amendment, the ATAD still addresses DD outcomes, yet it does not further explain the definition of a DD outcome.[348] The amended ATAD replaces the term *source*, and distinguishes between *investor jurisdiction* and *payer jurisdiction*, and states that the investor jurisdiction primarily denies the deduction.[349] Only when the investor jurisdiction omit to deny deduction (*e.g.* when the payer jurisdiction is a third State) then the payer jurisdiction shall deny deduction. Still, correspondingly the aforementioned, both states involved could argue that they are the payer jurisdiction. However, by introducing the term *investor*

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[345] See in this respect Stevens, T., & Fibbe, G. K. (2017). *Hybride hersenspinsels over BEPS en ATAD 2* (deel II: hybride entiteiten. NTFR Beschouwingen.

[346] EC (2016). *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market* (EU) 2016/1164, Article 2, par. 9(a).

[347] EC (2016). *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market* (EU) 2016/1164, Article 9, par. 1.

[348] EC (2016). *Council Directive Amending Directive as regards hybrid mismatches with third countries* (EU) 2016/1164. Article 1 amends Article 2, and fully replaces par. 9. Under the new Article 2, par. 9(g), a hybrid mismatch shall mean, *inter alia*, "*a situation where a DD outcome occurs.*"

[349] Article 9, par. 1 ATAD.

jurisdiction, which is, in the author's view, evidently State I, the likelihood of inconsistencies is at least reduced. The Netherlands, however, ties in with the terminology of the ATAD before its amendment via the codification of Article 12aa, paragraph 4 of the CITA 1969. For this reason, inconsistencies as outlined by Steven and Fibbe could still arise.[350]

5.2.1.3 SNC-Structures in a pre-ATAD Era

Although the frequency of its occurrence from a Dutch perspective is unknown,[351] it is conceivable that the discussed type of HMA manifest in Dutch context. As been shown under section 2.1.7.1, Dutch tax law does not yet provide for a provision that prohibits a DD outcome under a hybrid entity mismatch (unless the DD outcome finds its cause in a participation loan). So far, this opened the possibility for taxpayers to enter into an HMA involving hybrid entities. For instance, a Dutch BV could incorporate a partnership under French law, also known as a *Société en Nom Collectif* (SNC).[352] A SNC can, under circumstances, be considered as a non-transparent entity.[353] From a Dutch perspective, however, the SNC is considered to be a transparent entity.[354] The SNC could now enter into a loan with a third party in order to finance an investment in a French subsidiary (within a French tax group regime). A hybrid entity mismatch is in place since the interest payments related to this loan are deductible in both the Netherlands as well as in France due to the hybrid character of the SNC.

5.2.1.4 Implementation of the ATAD; Interdependence in Tax Law

Needless to say, it is conceivable that there are hybrid entity mismatches with a DD outcome in where the Netherlands occurs as the opposite State involved. Consequently, in order to be compliant with the ATAD, it is insurmountable that the Netherlands introduces a restriction to the right of deduction for both the situations in which the Netherlands is the investor State, and in which the Netherlands is the payer State, irrespective of the fact that the Netherlands should actually grant this deduction based on international allocation principles for corporate taxation. The Netherlands, or any other Member State, will sacrifice its tax autonomy when implementing a restriction to the right of deduction, making its tax system dependent on the treatment of an entity in the other State involved.

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[350] See in this respect also the explanatory memorandum of Article 12aa, par. 4 in the consultation document. Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 51.
[351] Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 16.
[352] See in this respect the articles L.221-1 – L.221-16 of the French Commercial Code.
[353] Weyl, M. (2018). *Challanges to Tax Autonomy in an Era of Conflicting Political Goals* (Subtopic 4: Tax Autonomy and Hybrid Mismatches, Reverse Hybrid Mismatches and Tax Residency Mismatches under the Anti-Tax Avoidance Directive), p. 10.
[354] Consider the list of foreign entities and their classification for tax purposes from a Dutch point of view as discussed under section 2.1.4.9 of this thesis. See https://download.belastingdienst.nl/belastingdienst/docs/lijst_gekwalificeerde_buitenlandse_samenwerkingsverbanden_dv0301z3pl.pdf

5.2.1.5 Who Bears the Risk?

One may wonder whether the ATAD provision against DD outcomes due to a hybrid entity mismatch actually pursuits the concept of source country entitlement. At first sight, the author tends to answer this question in the affirmative. Leaving aside the ambiguous terminology of the provision (which is, in the author's view, mitigated after amending the ATAD), it seems that the ATAD primarily assigns the deduction allowance to the Member State in where the payment, expenses or losses actually take place by disallowing the investor State to grant a deduction. Yet, the author cannot help but question whether the investor State is always the State wherein the duplicate payment takes place.

Consider again the example of the Dutch BV (entity A), incorporating a SNC (entity B) in France. Although from a Dutch point of view, the SNC can enter into rights and obligations, and is able to acquire assets under civil law (compare section 2.1.4.4), the Dutch BV has no limited liability for the debts and other obligations of the SNC (compare section 2.1.4.5), nor does the SNC has a capital divided into shares (compare section 2.1.4.6).[355] For this reason, the SNC is considered to be transparent from a Dutch point of view, meaning that the interest payments are considered to take place at the level of the BV.

Note that it is quite conceivable that the SNC as a hybrid entity does not make any profits. After all, insofar the SNC would make any profits, these profits would be included in both the tax base of the Netherlands as well as in the tax base in France (double inclusion income). Therefore, in order to prevent that profits realized in France are included in both France as in the Netherlands, it is the subsidiary of the SNC (entity C) which generally realizes profits. Due to the presence of a tax group regime in France, the interest costs incurred at the level of the SNC can be set-off against the profits made by entity C.

In the absence of any economic activities at the level of the SNC, it is unlikely that, would the SNC default its obligations arising from the loan, it can meet its obligations at any time by itself. Instead, it might well be the case that the creditors come up against a brick wall when demanding redress at the level of the SNC, in which case it is the BV (in the capacity of participant in the SNC) who will be held accountable for the obligations arising from the loan. With this in mind, one can argue that, in the light of source country entitlement, it is the Dutch BV who should be granted a deduction for the interest payments made at the level of the SNC, as the Dutch BV in fact bears the risks of the loan.[356] However, under the ATAD, it is the investor State and thus the Netherlands who should primarily deny deduction. The BV cannot deduct any interest costs insofar this has already been done at the level of the SNC.

[355] *Ibid.*
[356] Consider the location of risk as indicator of where value is created as discussed under section 3.3.3 of this thesis.

It is relevant to note that from a French point of view, the SNC is, in first instance, to be considered as a transparent entity as well.[357] The SNC can, however, become a non-transparent entity under French law if it opts for such a treatment.[358] In this light, the ATAD provision is even more remarkable. Even though the legislation of both Member States involved, in principle, consider the SNC as a transparent entity and allocate the loan as being held at the level of the BV in the Netherlands, it is the latter State that has to withdrawal its deduction. Under the ATAD, the choice of the SNC appears to be decisive. In fact, the choice of the SNC to opt for transparency or non-transparency under French law, determines whether the deduction will take place in the Netherlands or in France.

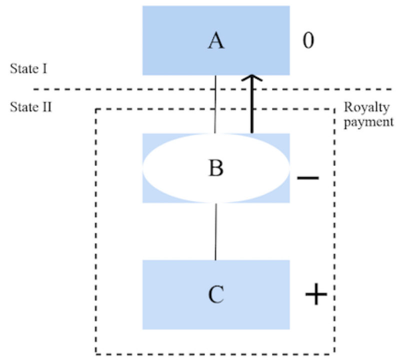
The lector may argue that the upper mentioned example is somewhat far-fetched. Instead, in most cases, it is the investor jurisdiction in where the duplicate deduction takes place, and who should waive its deduction allowance. Yet, even if this is true, one should note that the ATAD avoids any attempt to determine if this is actually the case. Insofar the concept of source country entitlement played any role in designing the primary response to a DD outcome under the ATAD, its role seems to be insignificant. The author cannot help but conclude that the mechanism of the provision against hybrid entity mismatches with a DD outcome can be inconsistent with the guiding principle of the OECD BEPS Project.

Moreover, the arbitrary character of the ATAD provision against DD outcomes cannot be disregarded in this respect. If an HMA with a DD outcome involves a third State, the Member State concerned shall deny the deduction of the DD payment, irrespective of whether this payment has its source in that Member State. Again, the concept of source country entitlement appears to be immaterial. A Member State may only allow deduction insofar the third State has already denied deduction.

5.2.2 Hybrid Entity Mismatches with a D/NI Outcome

State I considers entity B to be transparent. Therefore, it does not recognizes any transaction between entity A and entity B. From the perspective of State II, however, entity B is considered to be non-transparent. The transaction between entity A and entity B is therefore recognized, and a deduction of royalty payments is allowed in State II. Entity B can enter into a tax group regime with entity C and, consequently, the royalty payment can be deducted from the profits made by entity C. This structure is referred to as an HMA with a D/NI outcome under Article 2, paragraph 9(e) of the ATAD.

[357] Article 206, par. 3 of the French Tax Code.
[358] *Ibid, par. 2.*



5.2.2.1 Proposed Solution under the ATAD

Under the ATAD, the proposed solution states that the deduction is primarily refused in the Member State of the payer (*i.e.* State II).[359] This primary response shall be codified accordingly under the Dutch CITA.[360] If the deduction is not refused in that State (*i.e.* if a third State does not apply the primary rule), the amount of the payment is included in the profit in the Member State of the recipient.[361] This secondary rule shall be introduced accordingly under the Dutch CITA as well.[362] Again, this provision appears to be in line with its BEPS Action 2 counterpart (compare section 4.2.2).

Both the primary and secondary response are of relevance for the Netherlands, as the Netherlands does not yet provide for any provision that prohibits hybrid entity mismatches with a D/NI outcome. Until now, this opened the possibility for taxpayers to enter into an HMA involving hybrid entities. Elaborating on the example where a Dutch BV and a French SNC can trigger a DD outcome, that same structure can – with a few minor practical changes – result in a hybrid entity mismatch with a D/NI outcome.

5.2.2.2 SNC-Structures in a pre-ATAD Era

Although the frequency of its occurrence from a Dutch perspective is unknown,[363] it is conceivable that the discussed type of HMA manifest in Dutch context. For instance, consider again a Dutch BV which incorporates a French SNC. Assume that the BV has a trademark© on one particular medicine. The SNC pays royalties to the BV, allowing the SNC to sell that same medicine on the French market via entity C (the French subsidiary of the SNC). Insofar the SNC opts for being a non-transparent entity under French law, the French tax authorities will allow a deduction of the royalty payments at the level of that SNC, which can be set-off against the profits of entity C since they are part of the same tax group.

[359] Article 9, par. 2(a) ATAD.
[360] Article 12aa, par. 1 of the CITA 1969.
[361] Article 9, par. 2(b) ATAD.
[362] Article 12ab of the CITA 1969.
[363] Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 15.

The Dutch tax authorities, however, consider the SNC to be transparent and, therefore, do not recognize any royalty transaction. Consequently, the royalty payment is not included in the taxable base of the BV. Consistent with the primary rule of the ATAD, the French tax authorities will disallow a deduction of royalty payments at the level of the SNC. Where in a pre-ATAD era, the French tax authorities would allow the deduction based on the concept of residence, incorporation, or source, a deduction is now denied when the ATAD is in force.

5.2.2.3 Disregarding the Transaction; An Obvious Solution?

One can reason that, considering the guiding principle of the OECD BEPS Project, disregarding the transaction as if it never took place is not an obvious choice as a primary rule. Take for example a Dutch BV, with its POEM in the Netherlands. The BV is part of a large pharmaceutical MNE, that specializes in the development of medicines. The BV is owner of a large research center where a team of researchers is constantly working to develop new medicines. The BV is owner of a patent of a new medicine, developed in the research center. The BV grands a license to its subsidiary that allows this enterprise to make use of the patent. The subsidiary is considered to be a hybrid entity for the purpose of the ATAD. The Dutch BV gets a royalty payment as a remuneration in return. The royalty payments result in a D/NI outcome.

In view of this case, the author wonders how the primary rule, wherein deduction of the royalty payment should be denied at the level of the subsidiary, can be justified in the light of the concept of source country entitlement. As been shown under section 3.2.1.3, the taxation of income should be linked with the utilization of this income.[364] Since the trademark has been developed in the Netherlands, the income arising from the patent (*i.e.* the royalty payment) should be taxed in the Netherlands.[365] Yet, in intra-EU situations, it is the payer jurisdiction that denies the inclusion, as if the transaction never took place.

5.3 Measures Against Reverse Hybrid Entity Mismatches

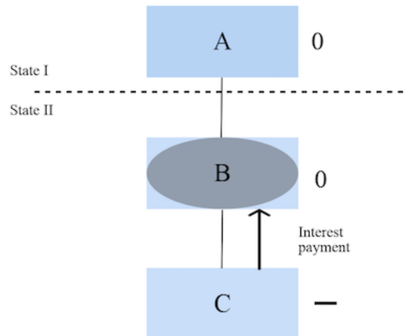
5.3.1 Reverse Hybrid Entity Mismatch with a D/NI Outcome

State I considers entity B to be non-transparent. From the perspective of State II, however, entity B is considered to be a transparent entity. An interest payment made from entity C to entity B is deductible at the level of entity C. State II considers the payment as to be received at the level of entity A in State I, given the transparent character of entity B from the perspective of State II. By contrast, State I consider the

[364] Consider in this respect employee location or the location of production capacity as value drivers under the concept of source country entitlement as discussed under section 3.3.1 and section 3.3.3 of this thesis.

[365] Intangible property is, in many cases, one of the most valueable aspects of a business. See in this respect Monsenego, J. (2015). *Introduction to transfer pricing*. Kluwer Law International, par. 3.3, p. 66. With reference to Miyatake, T., & Green, R.H. (2007). *Transfer pricing and intangibles*. IBFD, p. 19; and Verlinden, I., & Mondelaers, Y. (2010). *Transfer pricing aspects of intangibles: at the crossroads between legal, valuation and transfer pricing issues*. International transfer pricing journal, p. 49.

payment as to be received at the level of entity B, situated in State II. Consequently, none of the States involved tax the payments received, while a deduction is granted at the level of entity C. This structure is referred to as an HMA with a D/NI outcome under Article 2, paragraph 9(b) of the ATAD.



5.3.1.1 Proposed Solution under the ATAD

Faced with this situation, two ATAD measures are applicable: Article 9a of the ATAD, and the "regular" anti-hybrid measure against D/NI outcomes as discussed under section 5.2. Deduced from the preamble of the ATAD, it becomes clear that the provision of Article 9a is a *lex specialis* and prevails in case of convergence of both provisions.[366] Article 9a only applies when the reverse hybrid entity is incorporated under the laws of a Member State, or when the reverse hybrid entity is situated in one of the Member States. In that case "*the [reverse] hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that that income is not otherwise taxed under the laws of the Member State or any other jurisdiction.*"[367] This provision corresponds with the specific recommendation 5.2 of BEPS Action 2 regarding reverse hybrid entities (compare section 4.3.1.3).

This approach raises questions as to the scope of "*its income*". One may wonder whether this provision solely aims to include the payment causing the D/NI outcome.[368] Derived from the wording of the provision, it is arguable that the worldwide income of the reverse hybrid entity should be included in the tax base of the Member State involved, including income unrelated to the HMA, such as investment income. The Netherlands does not derogate from this terminology in its legislative proposal, yet clarifies its interpretation in the explanatory memorandum and explicitly excludes income that is not otherwise taxed under the laws of the other State or any other jurisdiction from the scope of application in case that the cause of the

[366] EC (2017). *Council Directive amending Directive 2016/1164, as regards hybrid mismatches with third countries*, par. 29 of the preamble.
[367] Article 9a ATAD.
[368] Stevens, T., & Fibbe, G. K. (2017). Hybride hersenspinsels over BEPS en ATAD 2 (deel II: hybride entiteiten). NTFR Beschouwingen, p. 4.

mismatch finds its origin in factors other than the hybrid element.[369] This might for instance be the case when the other State does not impose taxes in the absence of a CIT-system.

Insofar Article 9a of the ATAD is applicable, the regular anti-hybrid measure ceases its relevance as a D/NI outcome is no longer in place. However, when the reverse hybrid entity is situated in a third State, this measure is still of importance, as Article 9a of the ATAD will not apply under these circumstances (since the reverse hybrid entity does not fall within the geographical scope of the ATAD, compare section 5.1.1). Corresponding to all D/NI outcomes under the ATAD, the deduction is primarily refused in the Member State of the payer (compare section 4.3.1.1).[370] The secondary rule requires the Member State where the recipient (*i.e.* the reverse hybrid entity) is established to include the payment received in the tax base of the recipient. It is argued in literature that this secondary rule will remain a mere theoretical provision since Article 9a of the ATAD negates the transparent character of the recipient.[371] Accordingly, and in the absence of a secondary rule under BEPS Action 2, the secondary provision would not be compulsory to implement under the ATAD.[372] Yet, the situation in where the reverse hybrid entity is situated in a third State, and the participant resides within the EU appears to be overlooked. If the HMA is not eliminated in the third State, the secondary rule is still of importance and the HMA shall be neutralized at the level of the payee State. Although the entity situated in the EU might not be seen as receiving entity from the perspective of the Member State, it is considered as such from the view of the third State.[373] For this reason, the Netherlands emphatically includes the secondary rule for this type of mismatch as well.[374] The regular anti-hybrid measure will not be further discussed under section 5.3, as is already done so under the previous section.

5.3.1.2 CV/BV-Structures in a pre-ATAD Era

For the Netherlands, the relevance of the reverse hybrid entity mismatch starts on December 17, 1996, when the US' International Revenue Service (IRS) and the US' Department of Treasury issue final regulations relating to the classification of US' domestic and foreign entities.[375] The introduction of the check-the-box regulations (compare section 2.1.5.2) have provided a great deal of flexibility, and created many new alternatives for structuring US MNEs. US MNEs started to organize their branches and subsidiaries via the Netherlands in a way that optimizes both foreign and US taxation by so-called CV/BV-structures (the CV

[369] See in this respect the newly introduced Article 2, par. 3 of the CITA 1969. Compare the explanatory memorandum of the Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 1, p. 10 – 11, p. 34 – 35.
[370] Article 9, par. 2(a) ATAD.
[371] See in this respect Stevens, T., & Fibbe, G. K. (2017). *Hybride hersenspinsels over BEPS en ATAD 2* (deel II: hybride entiteiten. NTFR Beschouwingen, p. 5.
[372] Article 9, par. 4(a) ATAD.
[373] "*the payee jurisdiction is any jurisdiction where that payment or deemed payment is received, or is treated as being received under the laws of any other jurisdiction*". See in this respect Article 2, par. 9(c) ATAD.
[374] Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 13.
[375] CFR, Reg. 301.7701-1, *Classification of organizations for Federal Tax Purposes*; Treas. Dec. 8697, 1996-61, 66584, *Simplification of Entity Classification Rules*; Treas. Reg. 301.

and the BV are entities incorporated under the Netherlands civil law, and have previously been discussed under section 2.1.3.1).[376] A CV/BV-structure can be outlined as follows.

A limited liability company (LLC)[377] incorporated under US law participates in a Dutch CV. For Dutch tax purposes, the CV qualifies as a transparent entity. For this reason, any profit made by the CV is allocated to the participant situated in the US. The LLC, however, may elevate the tax transparency of the CV under US law if it so elect. Consequently, a reverse hybrid entity is in place. The LLC may now transfer excess cash into the CV, which, on its turn, may finance a Dutch BV (a passthrough entity for both US and Dutch tax purposes) by providing the BV with a loan, allowing the BV to refinance the worldwide activities carried out by subsidiaries of the MNE. A deduction of interest expenses made to the CV takes place at the level of the BV. Yet, both the Netherlands and the US neglect to tax the corresponding profits made by the CV with respect to this loan.

The same structure can be rigged with royalty payments. Instead of providing the CV with excess cash, the LLC might license or transfer IP to the CV. The BV processes the worldwide payments received from the use of IP by subsidiaries of the MNE, passing through the royalty payments received to the CV, which can be deducted from the taxable base of the BV. Again, the Netherlands or the US does not tax any of the corresponding royalty payments received at the level of the CV.[378]

5.3.1.3 Fictitious Residence

In the case at hand, Article 9a of the ATAD applies since the CV is incorporated under Dutch civil law. This means that the Netherlands should introduce a provision under which the CV shall be regarded as a resident of the Netherlands for CIT purposes, and shall be taxed to the extent that this income is not otherwise taxed under the laws of another State.

Hence, despite the fact that the CV (or any other partnership involved in a reverse hybrid mismatch) in its nature lacks legal ownership and has no capital divided into shares, the entity should, under the application of Article 9a ATAD, be considered as a legal entity as if it can enter into rights and obligations, and, consequently, bear the tax burden of profits made as if the entity itself is liable for debts and other obligations. The author notes that this approach contravenes with economic reality. In fact, the partnership does not have any legal personality. It can thus not be seen as a stand-alone entity, independently from its

[376] Examples of MNEs that enter or entered into CV/BV structures are Uber, Nike, Microsoft, Procter & Gamble, and Google. See in this respect Brandon Elliot, C. (2018). *Taxation of the Sharing Economy: Recurring Issues*, 72 Bull. Intl. Taxn. 4a/Special Issue, Journals IBFD.
[377] CFR, Reg. 88-76, 1988-2 C.B. 360.
[378] It should be noted that, as from 1 January 2018, the CV/BV-structure has considerably forfeited its tax incentive due to the US tax reform, more specific due to its introduction of CFC-legislation. See in this respect the US IRS Subpart F.

participants. Yet, although its participants are, from a civil law perspective, jointly and severally liable for the commitments entered into by the partnership, the partnership itself shall be considered as a resident for tax purposes and being taxed accordingly. In conclusion, the tax treatment of a domestic entity is fully dependent on the treatment of that entity from the perspective of the other States, or, in the case at hand, of the choice of the participant.

5.3.1.4 Beneficiary Partnership

The author advocates that the provision under Article 9a of the ATAD infringes with international allocation doctrines for corporate income in at least three ways. First, the provision conflicts with the *direct benefit principle* and its underlying *benefit theory* (compare section 3.1.2), which says that a State's tax claim is legitimate only when taxes are understood as a consideration for benefits provided to the individual through state activities. Yet, again, given its character, the partnership is often not able to receive benefits due to its lack of legal personality. Instead, in its capacity, the characteristics of a partnership tend to be more in line with an alliance, than with an entity that bears legal personality. Instead, one may argue that it is the participant that benefits from state facilities.[379]

5.3.1.5 Incorporation as a Justification Ground for CIT

Secondly, as discussed under section 3.2.1.2, an allegiance based on the mere fact that an entity is *incorporated* under the laws of a State is considered to be an insufficient basis for corporate tax jurisdiction. Even if that entity is a resident in that State by reason of its POEM or any similar criterion as well, a lack of allegiance is still in place as residing as such does not generate any income (compare section 3.2.1.1). Instead, taxation should take place where relevant business activities are conducted.

5.3.1.6 Value Creation at the Level of the Partnership

This raises the last question in assessing the provision in the light of source country entitlement; is the reverse hybrid entity really conducting relevant business activities that creates value? The examples provided under section 5.3.1.2 may very well lead to the conclusion that value creation takes place at the level of the investor in the US. Presumably, the excess cash is originating from profits generated in the US or elsewhere. Even if one concludes that the cash is generated at the level of the reverse hybrid entity, the risks connected to the grants of payments are in any event borne at the level of the investor (compare section 3.3.3).[380] With this in mind, one may wonder whether taxation of investment income at the level of the reverse hybrid entity is really compatible with the concept of source country entitlement.

[379] See in this respect the place of management as value driver under the concept of source country entitlement as discussed under section 3.3.3.
[380] Regarding the CV, consider Article 15 – 21 of the Dutch Commercial Code (CC).

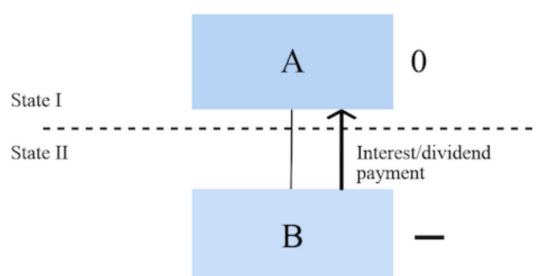
5.3.1.7 CV/BV-Structures and Licensing Payments

This same question can be asked in the context of royalty payments. Consider that IP is licensed or sold to the CV in the Netherlands, where the licensing rights – via a Dutch BV – are consigned to subsidiaries all over the world. It is again debatable whether value creation actually takes place in the Netherlands. Instead, it is very well possible that the IP has been developed in the US. If one argues that employee location should be the decisive factor when determining the place of value creation, it is up to the US to tax profits related to the IP (compare section 3.3.1). If one concludes that the place of value creation should be aligned with the place of consumer location (compare section 3.3.2), it is again inappropriate to assign all tax jurisdiction solely to the State in where the reverse hybrid entity is situated if consumers are located elsewhere. Once more, the concept of source country entitlement fell upon deaf ears when designing the ATAD.

5.4 Hybrid Financial Instrument Mismatches

5.4.1 Hybrid Financial Instrument Mismatches with a D/NI Outcome

Entity B is funded by entity A with an instrument that, due to its hybrid character, qualifies as equity in State I, while it is considered to be debt from the perspective of State II. As a result, a net deduction arises in State II, without a corresponding income inclusion in State I. This structure is referred to as an HMA with a D/NI outcome under Article 2, paragraph 9(a) of the ATAD.



5.4.1.1 Proposed Solution under the ATAD

Given its D/NI outcome, a mismatch due to a hybrid financial instrument is again dealt with in Article 9, paragraph 2 of the ATAD. Corresponding to the previously discussed D/NI outcomes under the ATAD, the primary responsibility to eliminate the HMA lies with the Member State where the payer is situated (*i.e.* State II) by refusing the deduction of the payment.[381] Insofar deduction at the level of the payer still takes place (*e.g.* because the payer entity is situated in a third State), then the defensive rule provides that the payment received shall be included in the profit of the recipient.[382] However, paragraph 30 of the preamble

[381] Article 9, par. 2(a) ATAD.
[382] Article 9, par. 2(b) ATAD.

stipulates that the linking rule of the PSD (compare section 2.3.4),[383] prevails over the ATAD provision.[384] The fact that the PSD prevails over the ATAD measures shall be codified accordingly under Article 12aa, paragraph 5 of the CITA 1969. As a quick refresher, the PSD is found on the starting point that in intra EU situations, elimination of the HMA shall take place at the level of the recipient by including the payment received. Therefore, in the context of hybrid financial instruments in intra-EU situations, it is actually the defensive rule that will take precedence over the primary rule. From a Dutch point of view, however, there is little point to implement the defensive rule since it is already applicable in both intra-EU and third State situations corresponding the PSD. However, the Netherlands implement both the primary as well as the secondary rule on a precautionary basis, as the occurrence of HMAs with financial instruments cannot be entirely excluded in this respect.[385]

BEPS Action 2 primarily denies the deduction at the level of the payer. If the payer jurisdiction defaults on the primary rule, then the secondary rule comes into force at the level of the recipient jurisdiction, indicating that the payment received should be included in the ordinary income of the recipient. The OECD's specific recommendation regarding hybrid financial instruments targets the participation exemption at the level of the recipient jurisdiction, arguing that jurisdictions providing the recipient with an exemption for dividends received should restrict that exemption to payments that have not borne tax at the level of the payer. The author concludes that the ATAD provisions as well as the PSD measures against hybrid financial instruments are devised in accordance with BEPS Action 2 (compare section 4.4.1).

5.4.1.2 RPS-Structures in a pre-ATAD Era

Consider a Dutch BV having a participation in an Australian Proprietary Limited (Pty Ltd.) expressed in RPS. Amongst other characteristics, RPS are distinct as compared to regular shares by the presence of a fixed term, and in the absence of voting rights. For this reason, the Australian tax authorities argue that, given its similarities with a debt instrument, the shares should be treated accordingly, despite its equity classification for civil law. In consequence, Australia allows a deduction for the intermittent payments made with regard to the RPS. Yet, as expressed in section 2.3.2, the Dutch Supreme Court attaches more importance to the classification of RPS under civil law. Therefore, the Netherlands consider the payments received as arisen from an equity instrument and grants the participation exemption.

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[383] EC (2014). *Council Directive (EU) 2015/121 of January 2015 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States,* Article 1, par. 2.
[384] EC (2017*). Council Directive amending Directive 2016/1164, as regards hybrid mismatches with third countries*, par. 30 of the preamble.
[385] Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 18.

The same structure could be set up in the reverse situation, *i.e.* the situation where a Dutch BV issues RPS to an Australian Pty Ltd. With reference to the previously discussed Unilever-case (section 2.3.2), it became clear that the Netherlands' tax authorities, in some situations, may reclassify an equity instrument to a debt instrument for tax purposes. Assume that this reclassification from equity to debt takes place in the situation at hand, whereas, from an Australian point of view, the payments received find its origin in an equity instrument.

5.4.1.3 Resistant to Hybrid Financial Instruments after the PSD?

Up to 2016, an HMA would be in place in present cases. Yet, as from the introduction of the amended PSD (compare section 2.3.3 to section 2.3.4), the Netherlands enhanced its tax legislation towards hybrid financial instruments by denying the application of the participation exemption to the extent that payments received are deductible for any CIT under any jurisdiction (*i.e.* an EU Member State or a third State). This means that the Netherlands, as recipient State, is not subsist for a hybrid financial instrument.

Considering the Netherlands as the paying State, the Netherlands shall abandon its deduction allowance pursuant the primary rule of the ATAD, insofar the third State does not include the corresponding payment in the tax base of the recipient. This is regardless the fact that a domestic taxpayer incurs expenses that, from a Dutch point of view, should lower its tax burden as the subject is resident in the Netherlands or is incorporated under Dutch law.

5.4.1.4 Debt versus Equity; a Perplexing Nature

It has been shown that interest payments are deductible at the level of the payer, and taxable at the level of the recipient. On the other hand, dividend payments are not deductible nor taxable at the level of the payer and recipient respectively. In literature, this is also referred to as the *classical approach* (compare section 2.3.2). This debt-equity divide is sometimes seen as a major obstacle for tax simplification, and scholars may argue that the distinction ought to be abolished.[386] For the purpose of this thesis, however, the author steps aside from this debate. Considering the classical approach to be the hegemonic doctrine in the field of international taxation, it serves as the starting point in the context of hybrid financial instruments.

The author considers the classical approach to comply with the concept of source country entitlement if consistently applied by both states involved. That means that dividends received shall not be taxed at the

[386] See, for instance, Miller, M.H. (1977). *Debt and Taxes*, 32 J. Fin. 2, p. 261; MacKie Mason, J.K. (1990). *Do Taxes Affect Corporate Financing Decisions?*,45 J. Fin. 5, p. 1471; Fama, E.F. & French, K.R. (1998). *Taxes, Financing Decisions, and Firm Value*, 53 J. Fin. 3, p. 819; Graham, J.R. (2000). *How Big are the Tax Benefits of Debt?*, 55 J. Fin. 5, p. 1901; Gordon, R.H. & Lee, Y. (2001). *Do taxes affect corporate debt policy? Evidence from U.S. corporate tax return data.*, 82 J. Pub. Econ. 2, p. 195; and Gordon, R.H. (2010). *Taxation and the Corporate Use of Debt: Implications for Tax Policy*, 63 Natl. Tax J. 1, p. 151.

level of the receiver since the payment made is a mere distribution of profits generated at the level of the payer. In other words, it may be presumed that value creation takes place in the State of the payer (compare section 3.3). By contrast, an interest payment is everything but a profit distribution. Instead, it is a cost that is made to finance business activities. One may argue that the recipient bears the risk of potential default of the borrower, and, by bearing this risk, the recipient is rewarded by way of interest revenues. Considering that risk management takes place at the level of the recipient, it is the recipient State where value is created (compare section 3.3.3).

5.4.1.5 Debt versus Equity; the ATAD as a Savior for Distortion?

Note that the classical approach is disrupted by the presence of hybrid financial instruments since a deduction is not followed by a corresponding inclusion. By interference via the ATAD measure, this imbalance is restored, but one may wonder whether this restoration always reflects the concept of source country entitlement.

Drawing the line between debt and equity is inherently arbitrary. Yet, in the search for a faithful reflection of the concept of source country entitlement, the author considers it of utmost importance to pursue economic reality rather than the legal form of the financial instrument. In lieu of the classification for civil law, the statutory books, or the purpose for some financial accounting standards, the contractual terms may be considered as relevant factors.[387] Think in this respect of the duration of the payment, the presence of potential events of default, the extent of subordination, the regularity of interest payments, the convertibility into equity, the presence of profit participation, voting rights, or other management rights. This means that, when the contractual terms of a financial instrument are considered, economic reality is pursued, and taxation based on the concept of source country entitlement can take place.

When analysing the characteristics of the previously discussed RPS, it becomes clear that the shareholder ranks ahead of ordinary shareholders on the winding-up of the company. Moreover, the shares are redeemable for cash or any other financial instrument (whether or not at the option of the holder). Therefore, the issuer has a contractual obligation *e.g.* a financial liability to the RPS-holder. This is even true for financial accounting.[388] With this in mind, it is very well possible that RPS should be considered as a debt instrument both on the level of the issuer as well as on the level of the holder.

[387] Blessing, P.H. (2012). *The Debt-Equity Conundrum - A Prequel*, 66 Bull. Intl. Taxn. 4/5, Journals IBFD, par. 4.1.1.
[388] Consider IAS 39 or IFRS 9. See in this respect also Alfredson, K., Leo, K., Picker, R., Loftus, J., Clark, K., & Wise, V. (2009). *Applying international financial reporting standards*. John Wiley & Sons Australia, par. 7.1 – 7.4.

Consider again the aforementioned RPS-structures, where Australia as the payer State reclassifies the RPS as a debt instrument, while the Netherlands as investor State omit to consider the characteristics of the financial instrument, relying on its civil classification. If one argues that – given the facts and circumstances – RPS should be classified as a debt instrument, then the classical approach advocates that the payments made should be deductible at the level of the payer, while being taxable at the level of the receiver.

This is exactly how the Dutch current measure against hybrid financial instruments operate when the Netherlands is the State of the recipient, while Australia is the payer State. Again, the Netherlands enhanced its tax legislation towards hybrid financial instruments by denying the application of the participation exemption to the extent that payments received are deductible for any CIT under *any* jurisdiction. In this context, the measure in force is in line with the concept of source country entitlement. This measure is, however, not the product of the ATAD. In fact, it is not really the work of the amended PSD either, as the latter modifications only concern intra-EU situations. Instead, it is the result of the Netherlands itself, that, on its own merits, denies deduction in case of a hybrid financial instrument with a third State.

Considering the reverse situation, where the Netherlands is the payer State, making a payment to a third State, it is the Netherlands that shall deny the deduction under the ATAD, insofar the recipient State has not already eliminated the HMA. In other words, it is being made to look as though there is a dividend distribution, even if the characteristics of the financial instrument prove to be otherwise.

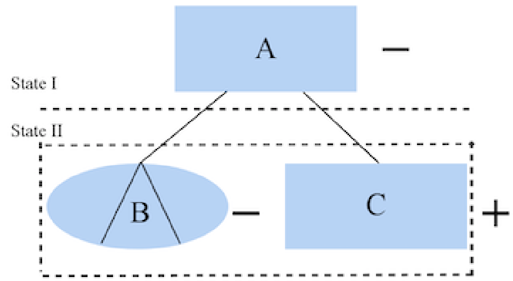
It is noted that – corresponding every ATAD measure – the ATAD measure against hybrid financial instruments may very well turn out to be in line with the concept of source country entitlement. However, if this is the case, then this is the result of a mere coincidence factor, while the ATAD measure itself does not aspire economic reality. An HMA is neutralized when taxation takes place in some State, or when deduction is denied somewhere. The concept of source country entitlement is again proven to be immaterial.

5.5 Hybrid Permanent Establishment Mismatches

5.5.1 DD Outcome

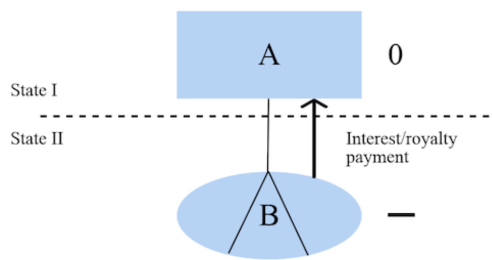
Suppose that branch B is recognized as a PE in State II by that same State. On the contrary, State I does not recognize this PE in State II. The PE in State II set off its expenditures against the profits of the subsidiary, as they are both parts of the same tax group. Hence, the same expenditures are deducted twice. This structure is referred to as an HMA with a DD outcome under Article 2, paragraph 9(g) of the ATAD. This provision has extensively discussed under section 5.2.1, and will therefore be no further examined under this section.

However, with reference to the final paragraph of section 2.4.3, it is relevant to note that the Netherlands will no longer grant an object exemption insofar a disregarded PE is in place.[389]



5.5.2 D/NI Outcome

Suppose that branch B is recognized as a PE in State II by that State, while this is not recognized as such by State I. A payment made from branch B to the head office is now deductible under the laws of State II, while it is not included in the tax base of entity A in State I. This structure is referred to as an HMA with a D/NI outcome under Article 2, paragraph 9(f) of the ATAD.[390]



It is debatable whether the Sarakreek-structure (compare section 2.4.4.2) falls within the scope of Article 2, paragraph 9(f) of the ATAD.[391] Given the rationale of the provision, the author tends to argue that this is the case. However, the provision explicitly states that the HMA has to find its cause in a "*deemed payment*". This is not the case in the context of a Sarakreek-structure, where an actual payment takes place from the subsidiary to the parent company, which is disregarded due to the presence of a tax group. In this light, one could argue that the Sarakreek-structure is covered under the previously discussed provision under Article 2, paragraph 9(e) of the ATAD (compare section 5.2.2). A prima facie inconsequential detail, considering that both provisions combat the HMA in the same manner. However, one should note that the defensive rule

[389] Consider Article 15e, par. 9 of the CITA 1969. See in this respect also the Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 68.
[390] PE mismatches may as well occur due to a diverted branch payment as described under Article 2, par. 9(c) ATAD, or under disregarded branch structures as described under Article 2, par. 9(d) ATAD. These structures will be disregarded under this chapter.
[391] Vakstudie Nieuws (2017). *Antibelastingontwijkingsrichtlijn 2 (ATAD 2)*, V-N 2017/36.3, p. 14 – 15.

is optional under provision Article 2, paragraph 9(f), while this is mandatory to implement insofar the HMA falls within the scope of provision Article 2, paragraph 9(e).

5.5.2.1 Proposed Solution under the ATAD

Given its D/NI outcome, a mismatch due to a PE mismatch is again dealt with in Article 9, paragraph 2 of the ATAD. Corresponding to the previously discussed D/NI outcomes under the ATAD, the primary responsibility to eliminate the HMA lies with the Member State where the (assumed) payer is situated (*i.e.* State II) by refusing the deduction of the payment.[392] Insofar deduction at the level of the payer still takes place (*e.g.* because the payer entity is situated in a third State), then the defensive rule provides that the payment received shall be included in the profit of the recipient.[393] This approach is in line with its BEPS Action 2 counterpart. However, the specific recommendation of BEPS Action 2 (consider section 4.5.2.3), that indicates that the residence jurisdiction should include any item of income that is not taxed by the branch jurisdiction (consider the under section 2.4.4.2 discussed Article 15ac, paragraph 5 of the CITA as an example) seem to be bypassed in the work of the ATAD.

5.5.2.2 Sarakreek-Structures in a pre ATAD Era

A Sarakreek-structure slightly differs from the repeatedly discussed "default" deemed payment mismatch (compare section 2.4.4.2, section 4.5.2, and section 5.2.2). Contrary to the default deemed payment mismatch, the existence of a PE is not a dispute under the Sarakreek-structure. It is the presence of a tax group that is the cause of the HMA. Nevertheless, the author considers the Sarakreek-structure to be more relevant to discuss, all the more because of its topicality and applicability for Dutch tax practice.

Since the introduction of Article 15ac, paragraph 5 of the CITA, the Sarakreek-structure has lost its relevance insofar the structure encompasses interest payments. Nonetheless, it has been observed that MNEs can still benefit from the use of the Sarakreek-structure when royalty payments are used. Consider for example a Dutch BV (BV A) charging a franchise fee (royalty) to its subsidiary (BV B), both part of the same tax group. BV B exploits its franchise rights via a PE in Spain. The royalty payments are deducted at the level of the PE in Spain, while BV A disregards the royalty payment received due to the presence of a tax group. In addition, the royalty payment is disregarded for the determination of a credit or exemption for the PE profits as well, increasing the credit or exemption at the level of BV B, and as a consequence, decreasing the taxable profits of BV B.

[392] Article 9, par. 2(a) ATAD.
[393] Article 9, par. 2(b) ATAD.

The tax inspector contested the disregard of royalty payments and, corresponding the previously discussed Sarakreek-structure with interest payments, this Sarakreek-structure with royalty payments has been submitted to the Supreme Court as well. Despite the call for reconsideration[394] of the initial Sarakreek-case,[395] the Supreme Court considers the approach described to be legitimate.[396] The Sarakreek-structure with royalty payments finds passage within Dutch tax law.

5.5.2.3 The ATAD Provision against Sarakreek-Structures; a Desirable Remedy?

It is by now known that the ATAD approach regarding D/NI outcomes primarily eliminate the mismatch at the level of the payer. This is, in the case at hand, the State where the PE is situated. Note however that none of the States involved refute the presence of a PE. In other words, both the Netherlands and Spain recognize an economic allegiance in Spain that justifies taxation (compare section 3.2.1.3), and both states involved allocate the royalty payments to the PE. It is Spain where the exploitation of the franchise takes place, where profits are generated, and where the expenditures that cohere with the generation of these profits should be considered. By the same token, it is (presumably) BV A in the Netherlands that developed or at least controls the IP. Correspondingly, the remuneration received for licensing that IP should be taxed where the utilization takes place. According to the guiding principle of the OECD BEPS Project, it is Spain where the deduction should take place, while the Netherlands should include the corresponding payment in the tax base of its domestic taxpayer. Once more, the primary response under the ATAD proves to hinder the rationale behind the concept of source country entitlement.

5.6 Tax Residency Mismatches

5.6.1 Tax Residency Mismatches with a DD outcome

Entity B is considered to be a resident for tax purposes both in State I and State II. Entity B makes an interest payment to a third party. This interest payment is set off against the profits of entity A in State I due to the application of a tax group regime, and against the profits of entity C in State II due to the reverse hybrid character of entity C. This structure is referred to as an HMA with a DD outcome under Article 2, paragraph 9(g) of the ATAD.

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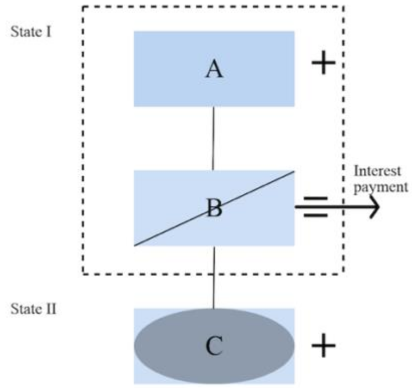
[394] Consider the comments on the revoked Supreme Court cases on 26 July 2012, no. 11/05670 and no. 11/05732.
[395] Supreme Court 4 June 1986, no. 23.614, BNB 1986/239.
[396] Supreme Court 3 June 2016, no. 14/05100, BNB 2016/171.



5.6.1.1 Proposed Solution under the ATAD

It is self-evident that the "regular" ATAD provision against DD outcomes (compare section 5.2.1.1) precludes application in case of a DD outcome due to a tax residency mismatch. After all, the regular provision distinguishes between *investor* and *payer* jurisdiction,[397] and such a distinction cannot be made in case of dual residency.[398] For this reason, Article 9b has been introduced in the amended ATAD, and reads as follows:

"The Member State of the taxpayer shall deny the deduction to the extent that the other jurisdiction allows the duplicate deduction to be set off against income that is not dual-inclusion income. If both jurisdictions are Member States, the Member State where the taxpayer is not deemed to be a resident according to the double taxation treaty between the two Member States concerned shall deny the deduction."[399]

Manifestly, a distinction is made between (i) tax residency mismatches in intra-EU situations and (ii) tax residency mismatches between an EU Member State and a third State.

(i) In intra-EU situations, a deduction is allowed only in the Member State where the taxpayer is considered to be resident under the tax treaty between the Member States concerned. However, it is unclear how to deal with an intra-EU tax residency mismatch in the absence of a tax treaty. The Netherlands comply with this provision by introducing Article 12ad in the Dutch CITA,[400]

[397] Article 9, par. 2 ATAD.
[398] See EC (2017). *Council Directive amending Directive 2016/1164, as regards hybrid mismatches with third countries*, par. 9 and par. 26 of the preamble. A tax residency mismatch with a DD outcome is not the result from a conflict in the characterization of financial instruments, payments and entities, or from the allocation of payments. For this reason, a tax residency mismatch with a DD outcome is discussed in a separate paragraph of the preamble.
[399] Article 9b ATAD.
[400] Dutch Ministry of Finance (2018). *Consultatiedocument Implementatie ATAD2, no. 8512*, p. 65 – 67.

yet does not provide for any clarity on how to deal with intra-EU tax residency mismatches where no tax treaty is in place.[401]

(ii) In third State situations, the deduction is denied in the Member State where the entity resides, yet only insofar the deduction in the other State is set off against income, not being dual inclusion income. For unknown reason, this "dual-inclusion-condition" is not applicable in intra-EU situations. Again, the Netherlands comply with this provision as well.[402]

5.6.1.2 Dual Residency Mismatch in a pre-ATAD Era; a Dutch/Belgium-Structure

Consider a Dutch BV with a Belgium BV as a subsidiary. The subsidiary, on its turn, holds an under Belgium law incorporated *Landbouwvennootschap* (LV), which is an entity for farmers situated in Belgium, with the aim of exploiting farming businesses.[403] Now assume that the Belgium BV is considered to be tax resident in the Netherlands by reason of its POEM, while it is considered as a resident in Belgium due to its incorporation under Belgium law and its exploitation of a farming business in the latter State.

According to their respective national legislation, the Belgium BV is now a resident taxpayer in both the Netherlands and in Belgium. Now assume that the Belgium BV enters into a loan with a third party in order to finance its farming businesses. The interest is deductible under both the Dutch and Belgium tax system. The deductible expenses made by the Belgium BV are consolidated with the profits made by the Dutch BV, as they are part of the same tax group under Dutch law. In Belgium, the deductible expenses are to be set off against the profits made by the LV, since the latter entity is deemed to be transparent under Belgium law.[404] From a Dutch point of view, the LV is considered to be non-transparent, and its profits made are therefore only taxed in Belgium.[405] A tax residency mismatch with a DD outcome is in place.

5.6.1.3 Deduction Denied in the State where Relevant Business Activities take Place

Having regard to its POEM, the Belgium BV is deemed to be resident in the Netherlands in the sense of the applicable tax treaty.[406] Under the ATAD, it is for this reason that the Netherlands shall grant a deduction, while that same deduction is denied in Belgium. However, in the case at hand, it is Belgium where the

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[401] Within the EU, the Netherlands did not agree on a tax treaty with Cyprus.
[402] See the newly introduced Article 12ad CITA 1969.
[403] Article 2, par. 3 of the Belgium Company Law Code (CLC) and Article 789 CLC.
[404] Article 29, par. 2 of the Belgium Income Tax Code (ITC); Com.IB 179/42.
[405] Consider the list of foreign entities and their classification for tax purposes from a Dutch point of view as discussed under section 2.1.4.9 of this thesis. See https://download.belastingdienst.nl/belastingdienst/docs/lijst_gekwalificeerde_buitenlandse_samenwerkingsverbanden_dv0301z3pl.pdf.
[406] Article 4, par. 3 of the Verdrag tussen het Koninkrijk der Nederlanden en het Koninkrijk België tot het vermijden van dubbele belasting en tot het voorkomen van het ontgaan van belasting inzake belastingen naar het inkomen en naar het vermogen, met Protocollen; Luxemburg, 5 juni 2001.

relevant business activities take place, namely the exploitation of farming businesses. Considering that the deductible expenses are connected to these business activities and with the concept of source country entitlement in mind, one may wonder whether the denial of deduction in Belgium – for the simple reason of residency in the opposite State for the purpose of the tax treaty – is the proper way to eliminate the HMA.

The allocation of deductible expenses to the resident State is even more remarkable in the light of the allocation rules under the tax treaty. This is because in the absence of residency in Belgium in the sense of the tax treaty, it might be very well conceivable that the business of the Belgium BV is carried out through a PE in Belgium (*e.g.* a farm).[407] If this is indeed the case, then the profits (and therefore also the related costs) that are attributable to the PE are allocated to the PE, and taxed (or deducted) accordingly in Belgium.[408]

5.6.1.4 Intra-EU Tax Residency Mismatch and Double Inclusion Income

Now assume that the Belgium BV makes (dual inclusion) profits. Elaborating on the aforementioned inconsistency (compare section 5.6.1.1) where – based on the wording of the provision – the dual-inclusion-requirement does not seem to apply in intra-EU situations, the question raises to which extent the DD outcome should be denied. Assume that the dual resident has a revenue of 1, makes deductible costs of 10, and has therefore a negative profit of 9. On balance, a DD outcome is in place for the amount of 9 and, considering the objective of the ATAD, it would be obvious to eliminate the DD outcome for that amount. However, based on the letter of the provision, the ATAD provision does not consider dual-inclusion income in intra-EU situations, while it explicitly mentions to consider dual-inclusion income in dual-residency mismatches between an EU Member State and a third State. The author cannot come up with a thorough reason that dual inclusion income should be disregarded in intra-EU situations, all the more because it is not disregarded in relation to third states. Despite the letter of the provision, the author deems it to be plausible that double inclusion income is taken into account in both intra-EU and third state situations.

5.7 Conclusion; the Arbitrary and at Times Ambiguous Directive (ATAD)

It became perceivable that the ATAD is broadly in line with the recommendations of BEPS Action 2 and its approach seems to close many of the existing loopholes where HMAs are used. Its similar approach with BEPS Action 2 also means that the ATAD is rather practical in its nature, and not so much grounded in legal principles. The author already elaborated on this poignant phenomenon in the context of BEPS Action 2 (compare section 4.9). However, the EU is governed in a different legal context as compared to the OECD.

[407] *Ibid.* Article 5.
[408] *Ibid.* Article 7.

In this light, the lack of any substantive doctrine under the ATAD is more worrisome. Where the OECD, in fact, provides a forum and issues non-binding guidelines for national tax systems, deprived of any legally binding force, it is the EU that is found on principles, values, and objectives,[409] that has exclusive competences,[410] and that may overrule national law.[411] The author believes that this demands for a more principle based approach where the concept of source country entitlement should serve as a starting point.

5.7.1 Economic Reality Neglected under the ATAD

The fact that the concept of source country entitlement is currently missing in the context of the ATAD has been shown by reference to specific examples. For instance, it does not seem to matter who actually bears the risk of a loan and who therefore should be allowed to deduct the corresponding interest costs (compare section 5.2.1.5). This approach therefore contravenes with the place where risk is borne as value driver under the concept of source country entitlement.

Also, it is immaterial whether in substance a cross-border IP exploitation takes place which justifies a *deduction inclusion outcome* rather than a *non-deduction non-inclusion outcome* (compare section 5.2.2.3). The cash-flow within an MNE is neglected and infringes the concept of source country entitlement since the location of production capacity or employee location as underlying value drivers are disregarded. In this light, it is worth considering reversing the primary and secondary rule with regard to D/NI outcomes, as the author presumes that inclusion in the recipient State as a primary rule better reflects the concept of source country entitlement. After all, it is most likely that a transaction takes place. For this reason, the author advocates to recognize the transaction, rather than to disregard it.

Moreover, the fact that a partnership cannot enter into rights and obligations on a stand-alone basis is insignificant (compare section 5.3.1.3); it is designated as a taxable, stand-alone entity for CIT purposes if a reverse hybrid entity mismatch is in place, even if the partnership is no beneficial owner of those profits to be taxed (compare section 5.3.1.4). This strongly encroaches on the concept of source country entitlement. If an entity, in the absence of legal personality, has no ability to conclude agreements, then it is plausible that risks are borne at the level of its management. Therefore, with reference to the place of management as value driver under the concept of source country entitlement, it is very likely that the place of value creations lies with this management.

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[409] Compare the Treaty on European Union (TEU).
[410] Article 3 of the Treaty on the Functioning of the European Union (TFEU).
[411] CJEU C-270/83, *EC vs French Republic*.

With regard to financial instruments, it is of no importance whether in substance, the characteristics give rise to qualify the financial instrument to be debt. Instead, it may very well be treated as equity from the perspective of both States involved to eliminate the HMA (compare section 5.4.1.5). By disregarding the contractual terms of the financial instrument, economic reality is deprived. As a consequence, the concept of source country entitlement is left out of consideration.

Furthermore, the presence of a PE may be disregarded in order to eliminate the HMA, even if both States involved recognize the presence of the PE under their national laws (compare section 5.5.2.3). Considering that a PE is a faithful reflection of the concept of source country entitlement par excellence, it is needless to say that the concept of source country entitlement is forfeit under this approach. As an alternative method, a PE mismatch might very well be prevented when attachment is found to the classification and allocation principles with regard to PEs as determined by the applicable tax treaty between the States involved. In the absence of a tax treaty, solutions may be found under the OECD MC as predominant model convention in EU context.[412]

Finally, when a tax residency mismatch is in place, it is ruled under the ATAD that a deduction shall only be allowed in the state of residence for the purpose of the applicable tax treaty, even if that same tax treaty would allocate the deduction to the other State (compare section 5.6.1.3 and section 5.6.1.5). Instead of allocating the deduction rights to the State of residence, the author is of the opinion deduction should take place in accordance with the applicable tax treaty with regard to tax residency mismatches. In the absence of a tax treaty, solutions may again be found under the OECD MC.

5.7.2 Inconsistencies in the Directive; a Hotbed for Discussion?

Besides the lack of any substantive doctrine for the allocation of corporate income, it is the absence of a carve-out for non-abuse that is notable as well (compare section 5.1.2.2). But the ATAD comprises more inconsistencies. For instance, it is not fully clear when an associated enterprise is in place in the sense of the ATAD (compare section 5.1.3.2), and some obscure terminology, such as the terms *source*, *payer jurisdiction*, and *investor jurisdiction* may cause discrepancies as well (compare section 5.2.1.2). See in this respect also the scope of "*its income*" in the context of a reverse hybrid mismatch (compare section 5.3.1.1). With respect to Sarakreek-structures, it is unclear under which provision the HMA shall be eliminated, causing ambiguities with respect to the (compulsory or mandatory) secondary provision (compare section 5.5.2). In addition, it is doubtful how to deal with tax residency mismatches in intra-EU situations in the

[412] Bulgaria, Croatia, Cyprus, Malta and Romania are the only EU Member States which are no member of the OECD. Nonetheless, these States have all agreed upon and ratified the OECD Multilateral Convention to implement tax treaty related measures to prevent BEPS.

absence of a tax treaty (compare section 5.6.1.1) and, in the same manner, how to deal with dual inclusion income (compare section 5.6.1.4).

The inconsistencies in the ATAD may lead to discrepancies between the national laws of the respective Member States, making it conceivable that they will cause new mismatches. Take, for instance, the term *associated enterprises*. As been shown under section 5.1.3.1 and section 5.1.3.2, an associated enterprise is in place through a participation of at least 50 percent. Moreover, an associated enterprise also includes an enterprise in which the taxpayer has a significant influence in the management of another enterprise. Yet, under the ATAD, it is not explicated when a taxpayer or an enterprise has a significant influence in the management of another enterprise. Therefore, the meaning of *significant influence* might be evidenced by the meaning of this term under national law, which is likely to be interpret differently among Member States. MNEs may use this divergence of interpretation to shift HMAs to Member States where they, for instance, are not considered as associated enterprises. This might very well be done by the use of an imported mismatch vehicle,[413] which, in the author's view, may still occur in intra-EU situations.[414] It should however be noted that such an import mismatch might be obviated by the introduction of the term *structured arrangement* (compare section 5.1.3.3).

Given the various inconsistencies under the ATAD, the author expects that its current approach will fuel new rounds of debate. The author is of the opinion that, with all efforts made under BEPS Action 2 and the ATAD, it is a missed chance not to address the very cause of HMAs – namely the disparities between States – by taking the concept of source country entitlement as a starting point in the solution. Under *Chapter 6*, the author will fumble for further alternative anti-HMA measures abided by the concept of source country entitlement.

[413] It goes beyond the scope of this thesis to further elaborate on the mechanism of an imported mismatch (compare section 1.5). The author will suffice with a reference to BEPS Action 2 and its incorporated examples. See OECD (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements*, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 83 – 91 and p. 341 – 422.

[414] The ATAD combats the import of HMAs "*except to the extent that one of the jurisdictions involved in the transaction or series of transactions has made an equivalent adjustment in respect of such hybrid mismatch.*" If an MNE shifts, for instance, a hybrid financial instrument between the Netherlands and Denmark to Denmark-Luxembourg as the HMA might not be recognized as such in the latter Member State(s) due to interpretation differences, it might be very well the case that this is not considered to be an imported mismatch under the ATAD. See Article 9, par. 3 ATAD. See also EC (2017). *Council Directive amending Directive 2016/1164, as regards hybrid mismatches with third countries*, par. 25 of the preamble.

6. Existing Approaches; a Comparability Analysis

As been shown under *Chapter 5*, the ATAD reveals a series of deficiencies, and the author takes a critical view with regard to its arbitrary approach. However, the author is well aware that criticism encompasses the obligation to come up with alternatives. Some alternative approaches have been provided for under *Chapter 5*. Yet, sound and thoughtful alternatives in EU context with respect to (reverse) hybrid entity mismatches and hybrid financial instruments can only be provided for after shedding light on the relevant legislative operations and political views of other Member States, all the more because of the diverging tax treatment of entities and financial instruments. This chapter, therefore, provides for a comparative of law among EUCOTAX countries and was referred to as the *comparative* aspect of this thesis in *Chapter 1*. A manifold of classification methods for entities will be drawn up under section 6.1. Different qualification methods for financial instruments are to be discussed under section 6.2. Alternative approaches for these respective HMAs will be discussed under section 6.3. A brief discussion will be provided for under section 6.4, where light will be shed on the overall appreciation of the ATAD among EUCOTAX countries.

6.1 Different Classification Methods for Entities

6.1.1 Classification Methods for Domestic Entities

Similar to the Netherlands, most other EUCOTAX countries discern capital companies (*i.e.* corporations) and partnerships to differentiate between domestic non-transparent entities and transparent entities respectively. Austria,[415] Switzerland,[416] Germany,[417] Spain, France,[418] Italy, Poland,[419] Sweden,[420] the UK, and the US are considerable examples in this respect. These countries use, likewise the Netherlands, certain criteria to distinguish non-transparent entities from transparent entities. Consider in this respect the presence of legal personality, the regulation of liability of the participants, the severability of capital into shares, and the transferability of the participations as identified under section 2.1.4. A notable exception is, however, the approach under Hungarian law, where every entity is considered to be non-transparent for tax purposes.[421]

[415] Rieder, B., & Huemer, D. (2016). *Gesellschaftsrecht*. facultas. wuv/maudrich, p. 39 and p. 44.
[416] See Article 49, par. 1(a) of the Swiss Direct Tax Act.
[417] Compare Dötsch, E., Pung, A., & Möhlenbrock, R. (2015). *Die Körperschaftsteuer*, Kommentar, 85. Auflage, Stuttgart.
[418] Article 8 and Article 206, par. 1 – 3 of the French Tax Act.
[419] Article 1, par. 2 of the Polish Corporate Income Tax Act.
[420] Article 36 – 37 of the Swedish Income Tax Act.
[421] Consider the Hungarian Corporate Income and Dividend Tax Act.

6.1.2 Classification Methods for Foreign Entities

With regard to the classification of foreign entities, it has been shown that there are four types of classification methods which can be identified (compare section 2.1.5).

6.1.2.1 Similarity Approach

Austria applies the similarity approach or *typenvergleich*, and depends its tax treatment of foreign entities on whether the entity is comparable with a corporation or partnership under Australian law.[422] Likewise, the Belgium tax authorities have the *lex societatis* as starting point,[423] and Germany assesses eight general criteria to the known German entity structures in order to determine the tax treatment of a foreign entity.[424] Spain and Sweden use the similarity approach as well.[425]

In France, there is no clear legislative provision that regulates the classification of foreign entities. The regime applicable to foreign entities is therefore mainly clarified by case law and administrative doctrine. In the case *Société Artemis SA*, the French Council of State ruled that the characteristics of the foreign entity and the applicable law which regulated its constitution and functioning must be considered. For instance, if the responsibility of the partners is limited, then the foreign entity cannot be assimilated as a partnership.

Switzerland derives the classification of foreign entities from case law as well. A case regarding the taxation treatment of a general partnership incorporated in Guernsey,[426] and two cases with respect to the tax treatment of a US LLC are of particular importance.[427] In the first case, the Swiss Supreme Court stated that the classification under foreign civil law is decisive for the tax treatment under Swiss tax law. In the other case, however the Swiss Supreme Court stated that the classification under civil law cannot be decisive on a stand-alone basis. Therefore, the Swiss Supreme Court stated that a "*pragmatic mix of methods*" is appropriate. First and foremost, the foreign entity should be compared to Swiss entities corresponding the similarity approach. The tax treatment in the State of incorporation is of secondary importance.

The classification of foreign entities from a UK perspective is determined by guidance from HMRC (the UK tax authorities) and case law as well. HMRC provides for a list of the entities and their corresponding classification for UK tax law. However, even if a certain type of entity is listed, this does not necessarily confirm its classification. For instance, the UK Court held that a US LLC is deemed to be transparent for

[422] Section 1 and 3, par. 133(f) of the Austrian Corporate Income Tax Directive.
[423] Article 110 – 111 of the Belgium International Civil Code.
[424] Bundesministerium für Finanzen (2004). *BStBl. I 2004, 411 IV.*
[425] See with respect to Sweden Article 2:5a of the Swedish Income Tax Act.
[426] Swiss Federal Supreme Court judgement 2C_664/2013.
[427] Swiss Federal Supreme Court judgement 2C_895/2013.

UK tax purposes despite the HMRC's guidance.[428] Broadly, the characteristics of the entity must be determined, and an assessment is made after comparing these with the UK characteristics of domestic entities.[429] An overall conclusion is reached by considering all the factors, though some may have more significance than others.

6.1.2.2 Elective Approach

In the US, some foreign entities are per definition non-transparent entities under the check-the-box regulations (e.g., the French *societe anoyme*). An entity organized under foreign law that is not required to be classified as a corporation under the check the-box regulations is an *eligible entity* and as such eligible to elect its classification for US tax purposes.[430]

Notwithstanding its regular approach, certain forms of transparent entities can opt for non-transparency and inversely, some non-transparent entities can opt for a transparent treatment for tax purposes in France. As a general principle, the French Tax Code establishes a "*semi-transparency*" regime, which means that a partnership is considered to be a separate legal entity yet still passes through its profits, losses, and credits to its partners.[431] The semi-transparency regime mainly concerns partnerships but can be extended to other legal forms if the shareholders opt for this regime.[432]

As part of its tax reform in 2004, Italy adopted new rules under which domestic entities can elect to be treated as tax transparent for tax purposes.[433] Lastly, farming companies are deemed transparent for tax purposes but can opt for non-transparency with unanimity of votes of the participants under Belgium law (compare section 5.6.1.2).[434]

6.1.2.3 Fixed Approach

Corresponding its treatment for domestic taxpayers, Hungary treats every foreign entity as non-transparent for tax purposes.

6.1.2.4 Symmetrical Approach

Poland treats a foreign entity according to the tax treatment of its domestic State.[435]

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[428] Anson v Commissioners of HMRC [2015] UKSC 44.
[429] Memec Plc v The Commissioners of Inland Revenue [2006] EWCA Civ 158.
[430] Treas. Reg. par. 301.7701-3(a).
[431] Article 8 of the French Tax Act.
[432] Article 239a of the French Tax Act.
[433] Consider Rossi, M. (2005). *Italy's New Check-the-Box Rules*. Tax Notes International, *39*(4), p. 329 – 342.
[434] Article 29, par. 2 of the Belgium Income Tax Act.
[435] Article 1, par. 3(2) of the Polish Corporate Income Tax Act.

6.2 Different Qualification Methods for Financial Instruments

Besides the classification methods for entities, it is relevant to examine the different qualification methods for financial instruments, as the parallel application of different methods are the cause of hybrid financial instrument mismatches.

It is remarkable that the debt-equity distinct is not clarified under the tax law of any EUCOTAX country. Instead, it is common that reference is made to other sources of law, where two tendencies can be distinguished; (i) the reference to civil law and (ii) the reference to local accounting standards. The debt-equity distinct of some of the EUCOTAX countries will be discussed in de subsequent sections.

6.2.1 Qualification of Financial Instruments with Reference to Civil Law

Belgium considers the intention of the parties to share profits and losses of the entity, the subordinated nature of the instrument, the presence of a sufficient amount of capital to accomplish the statutory purpose, the presence of a maturity date, the nature of the creditor or the presence of a right of control, and the presence of a collateral to determine whether a financial instruments qualifies as debt or equity.[436]

Although the terms debt and equity are used under Swiss civil law,[437] a legal definition is not provided for, and both terms are to be interpreted.[438] In general, Swiss law considers all shares, participation rights and jouissance rights to be equity; whereas it considers all the bond or corporate loans to be debt.[439]

The UK's Companies Act mentions that the statement of capital must determine the total number of shares of the entity as well as the aggregate nominal value of those shares. Therefore, equity is limited to funds stated in the statement of capital.[440] As for debt, its classification is based on the common law of contract, and the parties involved can determine the terms of their agreement. Therefore, the capital that is not registered but created according to contract can qualify as debt and unless not explicitly mentioned, does not impose statutory shareholder rights.[441]

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[436] Van Gompel, J. (2003). *Het onderscheid naar Belgisch intern fiscaal recht tussen inbreng en geldlening*, p. 731.
[437] Article 663 (b) of the Swiss Code of Obligations.
[438] Hongler, P. (2012). *Hybride Finanzierungsinstrumente im nationalen und internationalen Steuerrecht der Schweiz*. Schulthess, p. 17.
[439] *Ibid*. p. 20.
[440] Section 9(4) of the UK's Companies Act.
[441] Schön, W., Beuchert, T. A., Roesener, A., Gerten, A., Haag, M., Heidenbauer, S., Osterloh-Konrad, C. (2009). *Debt and equity: what's the difference? A comparative view*, p. 88 – 89.

6.2.2 Qualification of Financial Instruments with Reference to Accounting Standards

France analyses the features of the instrument carried out through civil law principles. The legal characteristics of the instrument is key element to determine its classification. When the tax treatment of a transaction is not determined, the GAAP shall apply.[442] An opinion published in July 1994 by the Conseil Superior of the Board of Chartered Accountants estimated that there are three types of financial instruments: equity; non-reimbursable proceeds and other assimilated instruments; and debts. The opinion defined equity as a non-reimbursable financial instrument which does not provide for any due remuneration on the liability side of the balance sheet in an absence of payment and which cannot be deducted by the issuer. The opinion characterized a transaction as debt if its redemption is not at the discretion of the borrower or is not executed through a mandatory delivery of another equity instrument.

Hungary makes reference to its local GAAP as well, yet without considering its civil law.[443] According to the Hungarian Act on Accounting, a debt-claim is the relationship where the debt-holder is obligated to refund the loan received with the respective interest.[444] In contrast, equity provides the holder a property right. Likewise, for the distinction of equity and debt for tax purposes, the Spanish CITA refers to local GAAP as well.[445]

6.3 An Alternative Approach in a Unity without Uniformity

6.3.1 Disregard the Elective Approach

The major part of the EUCOTAX countries assess the classification of a foreign entity according to their own judgements derived from national legislation, jurisprudence, or degrees issued by the national tax authorities or other governmental or non-governmental institutions. It is therefore conventional to consider and compare the characteristics of foreign entities to similar entities under national law. This outcome is illustrative and shows the importance that Member States attach to their tax autonomy, which they, according to Essers, "*so eagerly seem to defend with the argument of the democratic deficit of the EU*."[446]

It is unknown and moreover difficult to assess how often the parallel exercise of the similarity approach leads to the occurrence of HMAs. However, its occurrence is likely to be limited under the parallel exercise of the similarity approach for the simple reason that most EUCOTAX countries – to a greater or lesser

[442] Article 38-quarter of the Appendix III of the French Tax Code.
[443] LXXXI, Section 4, par. 28/b of the Hungarian Corporate Income and Dividend Tax Act.
[444] Secion 3, par. 6 of the Hungarian Act on Accounting.
[445] Article 10 of the Spanish Corporate Income Tax Act.
[446] Documents of the First Chamber of Parliament, *International Tax (Treaty) Policy,* 2013-2014, 25087, no. 16, p. 4 – 5.

extend – use comparable criteria to distinguish between non-transparent entities and transparent entities. Nonetheless, empirical research should be performed to confirm or deny this position.

Occasionally, it is the elective approach that is used, where it is the entity itself (or its participants) that elects its tax treatment. It has already been advocated that this approach is a Pandora's Box for HMAs (compare section 2.1.5.2). After all, if an entity can be excluded from the scope of CIT if it so elects, disregarding critical factors such as the presence or absence of legal personality, the ability to enter into rights and obligations, the possibility to acquire assets on a stand-alone basis, and the presence or absence of limited liability for debts and other obligations, which are all essential criteria to assess where value creation has its source, then the author questions whether the preservation of the elective approach really safeguards taxation grounded in the concept of source country entitlement. For this reason, the author is of the opinion that, in order to reduce the frequency of HMAs, while pursuing the concept of source country entitlement, a check-the-box regime or any similar elective approach should be disregarded when a (reverse) hybrid entity mismatch is in place.

6.3.2 IFRS and Hybrid Financial Instruments

It became perceivable that none of the EUCOTAX countries analyzed depends the qualification of a financial instrument on the tax treatment of the opposite State. Instead, reference is often made to national civil law or local GAAP. With regard to civil law, it is often the mere legal form of the financial instrument that is considered, while the contractual terms of the financial instruments are disregarded in this respect.[447] Yet, in the search for a faithful reflection of the concept of source country entitlement, it is precisely these contractual terms that are of importance (compare section 5.4.1.4 and section 5.4.1.5).

Although the author considers it to be more likely that – with reference to local GAAP – facts and circumstances are considered and therefore economic reality is pursued, it is not inconceivable that both States involved qualify the financial instrument in a different manner. Instead, attachment could be found to international accounting principles.

At the time this thesis was written, IFRS are required for domestic public companies in 166 different States.[448] IFRS is very prescriptive in the way it distinguishes between debt and equity instruments and provides for specific, substance-based rules to address the key principles of debt versus equity.[449] IFRS

[447] In Dutch context, see Article 2:366 and Article 2:373 – 2:376 of the Dutch Civil Code, which are part of Dutch GAAP.
[448] See https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/.
[449] IAS 32, paragraph 15.

distinguishes itself from civil law by stating that the substance of a financial instrument, rather than its legal form, governs its qualification.[450] For this reason, the author is of the opinion that, in order to reduce the frequency of HMAs while pursuing source country entitlement, attachment should be found to IFRS when a hybrid financial instrument mismatch is in place.[451]

6.4 Conclusions in a Single-Minded EU; Good Vibes Only

In a world marked by globalization, technologies and removal of barriers between States, it is broadly acknowledged that one State alone would be powerless in the fight against aggressive tax planning strategies at the international scale. This is recognized by France, who states that the increasing speed of globalization requires fast and coordinated countermeasures.[452] Germany is likewise in favor of minimum standards but raises its concerns with regard to double-taxation matters.[453] The same opinion is expressed by Austria, yet with the apprehension that the ATAD could detract the competitive position of EU States relative to third States.[454] Furthermore, no critical voices were raised from the side of Poland, Spain, and Hungary. This apparent unity among EU Member States is to their credit. However, given the shortcomings of the ATAD as observed under *Chapter 5*, the author questions whether this ostensible harmony and the omission of criticism justifies optimism.[455]

[450] IAS 32, paragraph 18.
[451] Consider IAS 32/39 or IFRS 9. See in this respect also Alfredson, K., Leo, K., Picker, R., Loftus, J., Clark, K., & Wise, V. (2009). *Applying international financial reporting standards*. John Wiley & Sons Australia, par. 7.1 – 7.4.
[452] In France, there is the fundamental principle of subsidiarity posed by Article 88-6 of the French Constitution. The French Senate decided the proposition of ATAD based on Article 115 of the TFEU complied with the principle of subsidiarity because the objective pursued by the directive required a common European Union initiative on the entire internal market. The action pursued by ATAD cannot be achieved individually by the Member States.
[453] Oppen, in IStR 2016 797 (803); Fehling. in DB 2862 (2863).
[454] Haslehner, W. (2018). *Anti-BEPS-Richtlinie: Konzernsteuerrecht im Umbruch?*; and Lang, M. (2017). *Die Anti-Tax-Avoidance Richtlinie*, p. 359 – 362.
[455] Only Sweden objected to the ATAD proposal. An objection regarding non-compliance with the principle of subsidiarity was issued in accordance with Article 5 TEU and Article 6 of Protocol (No 2) on the application of the principles of subsidiarity and proportionality. The response to the Swedish parliament contained a reference to Article 115 TFEU, stating that direct taxation falls within the shared competence and that anti-tax avoidance measures only can be effective through coordinated EU legislative acts.

7. Conclusions and Recommendations

For the sake of clarity, the thesis framework shall be briefly outlined before drawing conclusions.

HMAs are caused by the autonomous application of different tax qualification or classification methods among States and harm the proper functioning of the internal market. Hence, the EU Council provides for anti-HMA measures by establishing the ATAD corresponding the guiding principle of the OECD BEPS Project, which ensures that *profits are taxed where economic activities which generate these profits are performed, and where value is created*. The implementation of the ATAD could be perceived as a significant move towards EU law competence over national tax legislations. Yet, the question remains how the ceding of tax competencies relates to a Member State's tax autonomy as expressed by international allocation principles for the taxation of corporate income.

Moreover, it is not covered by the work of the OECD or the EU whether or how the measures against HMAs contribute to the guiding principle of the OECD BEPS Project, nor is the location of value creation further substantiated. Therefore, for the purpose of this thesis, the location of value creation has been developed with reference to *the concept of source country entitlement*. Some indicators that could be linked up with the place of value creation have been provided for, such as employee location, consumer location, and other value drivers such as the location of production capacity, the location of management, the location where risk is borne, or the location where capital is raised.

Throughout this thesis, the following research question was guiding:

To what extent are the anti-hybrid measures of the Anti-Tax Avoidance Directive pursuing the guiding principle of the OECD BEPS Project as expressed by the concept of source country entitlement and how does the implementation of the Anti-Tax Avoidance Directive influence international allocation principles for the taxation of corporate income?

7.1 Conclusions

Based on the findings in this thesis, the following can be concluded:

(i) Grounded in the principle of sovereignty and the direct benefit principle, taxation should be perceived as a contribution which flows from the relationship between a State and an individual, and a State's tax claim is legitimate only in those cases in which taxes are understood as a consideration for benefits provided to the individual through State activities. Under BEPS Action 2, however, it appeared that the proposed recommendations do not need to be harmonized around any of these principles or any other substantive doctrine or concept for the international allocation of corporate income. Instead, the OECD does not bother to determine which State has lost revenue, and which State should benefit by a greater revenue collection. Any rule that reverses the effect of the HMA seems to be acceptable, and the recommended solutions are entirely agnostic as to which State should collect the revenue.

(ii) It became perceivable that the ATAD is broadly in line with the recommendations of BEPS Action 2, and its approach seems to close many of the existing loopholes where HMAs are used. However, its parable design also means that the ATAD is rather practical in its nature, and not so much found on existing international allocation principles for the taxation of corporate income. Clearly, this verdict is already distressing in the context of OECD BEPS Action 2. Yet, the EU is governed in a different legal context as compared to the OECD, and the lack of any substantive doctrine under the ATAD is more worrisome. Where the OECD, in fact, provides a forum and issues non-binding guidelines for national tax systems, deprived of any legally binding force, it is the EU that is found on principles, values, and objectives, that has exclusive competences, and that may overrule national law. A Member State's tax autonomy appeared to be lost from sight by establishing BEPS Action 2 and the ATAD, its legislators showed to be too ready to sacrifice tax principles to political expediency, and arbitrariness is evidently present under the ATAD.

(iii) This means that existing international tax rules are being reassessed and reformed, and taxation on the basis of residence, incorporation, or source under national legislation is no longer obvious. Instead, the tax treatment of an instrument or entity in one State is dependent on the tax treatment of that instrument or entity in the other State due to the introduction of linking rules. The ATAD forgoes international allocation principles for the taxation of corporate income *to ensure that tax is paid where profits and value are generated*. Regrettably, the fact that the EU will not achieve this objective has been discoursed and exemplified in the course of this thesis:

a. It does not seem to matter who actually bears the risk of a loan and who should therefore be allowed to deduct the corresponding interest costs, which approach therefore contravenes with the place where risk is borne as value driver under the concept of source country entitlement.

b. It is immaterial whether in substance a cross-border property exploitation takes place which justifies a *deduction inclusion outcome* rather than a *non-deduction non-inclusion outcome* (which is now the primary response under the ATAD). The cash-flow within an MNE is neglected, which infringes the concept of source country entitlement since the location of production capacity or employee location as underlying value drivers are disregarded.

c. The fact that a partnership cannot enter into rights and obligations on a stand-alone basis is insignificant under the ATAD. Instead, the partnership shall be designated as a taxable, stand-alone entity for CIT purposes if a reverse hybrid entity mismatch is in place, even if the partnership is no beneficial owner of those profits to be taxed. This strongly encroaches on the concept of source country entitlement. If an entity, in the absence of legal personality, has no ability to conclude agreements, then it is very likely that risks are borne at the level of its management. Therefore, with reference to the place of management as value driver under the concept of source country entitlement, it is very likely that the place of value creations lies with this management, where it should be taxed accordingly.

d. It is of no importance whether in substance, the characteristics of a financial instrument give rise to qualify the financial instrument to be debt. Under the ATAD, it may very well be treated as equity from the perspective of both States involved to eliminate the HMA. By disregarding the contractual terms of the financial instrument, economic reality is deprived. As a consequence, the concept of source country entitlement is left out of consideration.

e. A PE is a reflection of the concept of source country entitlement par excellence. Yet, the presence of a PE may be disregarded under the application of the ATAD in order to neutralize an HMA, even if both States involved recognize the presence of the PE under their national laws. Needless to say, the concept of source country entitlement is forfeit under this approach.

f. When a tax residency mismatch is in place, it is ruled under the ATAD that a deduction shall only be allowed in the state of residence for the purpose of the applicable tax treaty, even if that same tax treaty would allocate the deduction to the other State by virtue of the presence of a PE.

(iv) The current approach of the ATAD does not suffice to achieve taxation in the jurisdiction of profit- and value creation. With all the efforts made by the OECD as well as by the EU Council to tackle HMAs, it is a missed chance not to introduce measures that are more modeled around the concept of source country entitlement. The author rejects the ATAD in the absence of any principle or overarching doctrine for the allocation of taxation of corporate income and comes up with alternatives.

7.2 Recommendations

Based on the findings in this thesis, the author recommends the following:

(v) With regard to the primary rule, the ATAD should be modeled around the concept of source country entitlement, where deduction takes place where costs are effectively incurred, and where taxation takes place where value is created. HMAs will then be eliminated within the internal market, while existing doctrines for the international allocation of corporate income are adhered, and where economic reality is pursued. Various changes may contribute to a system of anti-hybrid measures where the OECD BEPS mantra serves as a starting point.

(vi) It is worth considering disregarding the elective approach in the event of an HMA, and to rely on the default classification methods of the State concerned. After all, if an entity can be excluded from the scope of CIT if it so elects, disregarding critical factors such as the presence or absence of legal personality, the ability to enter into rights and obligations, the possibility to acquire assets on a stand-alone basis, and the presence or absence of limited liability for debts and other obligations, which are all essential criteria to assess where value creation has its source, then the author questions whether the preservation of the elective approach really safeguards taxation grounded in the concept of source country entitlement. For this reason, in order to reduce the frequency of HMAs, while pursuing the concept of source country entitlement, a check-the-box regime or any similar elective approach should be disregarded when a (reverse) hybrid entity mismatch is in place.

(vii) The occurrence of hybrid financial instruments may be reduced when the States involved forgo their qualification according to national civil law, commercial law, tax law, or local GAAP, and instead base their qualification on international accounting standards such as IFRS. At the time this thesis was written, IFRS are required for domestic public companies in 166 different States. IFRS are very prescriptive in the way it distinguishes between debt and equity instruments and provides for specific, substance-based rules to address the key principles of debt versus equity. IFRS distinguishes itself from civil law by stating that the substance of a financial instrument, rather than its legal form, governs its qualification. For this reason, the author is of the opinion that, in order to reduce the frequency of HMAs while pursuing source country entitlement, attachment should be found to IFRS when a hybrid financial instrument mismatch is in place.

(viii) A PE mismatch might very well be prevented when attachment is found to the classification and allocation principles with regard to PEs as determined by the applicable tax treaty between the States involved. In the absence of a tax treaty, solutions may be found under the OECD MC as predominant model convention in EU context. Note that the alignment of anti-hybrid measures with tax treaties ties in with global developments with regard to the purpose of the tax treaty. Not only do States enter into tax treaties for the elimination of double taxation, but they are increasingly being entered into for the prevention of tax evasion and tax avoidance as well.

(ix) Instead of allocating the deduction rights to the State of residence, the author is of the opinion deduction should take place in accordance with the applicable tax treaty with regard to tax residency mismatches. In the absence of a tax treaty, solutions may again be found under the OECD MC.

(x) The author expects a significant amount of HMAs to be neutralized with the abovementioned system of prevention. Insofar an HMA still takes place, the current ATAD measure against DD outcomes could remain intact. With regard to D/NI outcomes, however, it is worth considering reversing the primary and secondary rule, as the author presumes that inclusion in the recipient State as a primary rule better reflects the concept of source country entitlement. After all, it is most likely that a transaction takes place. For this reason, the author advocates to recognize the transaction rather than to disregard it.

(xi) When the applicable measure does not neutralize the HMA compliant to the concept of source country entitlement, the secondary rule supersedes the primary rule. To determine the source State, attachment may be found on a multitude of value drivers as discussed under *Chapter 3*. Dispute resolutions may be found in mutual agreement procedures, where attachment can be found on BEPS Action 14. It is acknowledged that the current ATAD approach is less burdensome to apply compared to suchlike case-by-case assessments. However, the author is of the opinion that convenience may not be a predominant argument when designing counter measures against HMAs within the EU, especially when these measures contravene with current doctrines and principles for the allocation of taxing rights of corporate income.

(xii) Obviously, a method of this kind requires a well-considered embedding in a Member State's national legal order and the design and implementation needs to be well thought through. Nonetheless, the legislative challenges are not expected to substantially differ from the current approach, while the recommended approach pursues the concept of source country entitlement.

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