The ATAD 2 anti-Hybrid measure a light on the horizon?

The effectiveness of the anti-hybrid mismatch measure under the

European Anti-Tax Avoidance Directive II (ATAD 2), a Dutch view

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Preface

Many US multinationals are taking advantage of differences of tax characterization of entities among countries through Hybrid Mismatch Arrangements. By shifting the profits to low taxed jurisdictions and in absence of actual economic activities, the tax base of States gets eroded. For this reason, the OECD started the Project " Base Erosion and Profit Shifting" and ended in 2015 with inter alia BEPS Action 2 to counter undesired outcomes caused by mismatch arrangements due to aggressive tax planning structures. The EU welcomed this project and started on European level in line with fair taxation and transparency with the Anti-Tax Avoidance Directives. The amended version extended the first Directive since it was not entirely in line with the Recommendations of the OECD BEPS Action 2. The Netherlands already implemented ATAD 1 since 1 January 2019, and are planning to adopt ATAD 2 in 2020. However, the reverse hybrid entity measure is postponed till 2022. With the latter provision, the Dutch CV/BV structures will be tackled. The CV shall be treated as a stand-alone entity and taxed accordingly. Already in 2018, the US took measures against tax avoidance with the US Tax Reform and introduced the CFC-rule. Although ATAD is not entirely in line with BEPS Action 2, it neutralizes the undesired outcomes by solving the mismatch problem at the cause. So, the reverse hybrid entity provision of Article 9a of ATAD will have a substantial impact on CV/BV structures in the Netherlands.

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I List of abbreviations

ATAP	Anti-Tax Avoidance Package
BEPS	Base Erosion and Profit Shifting
CBC Reporting	Country-By-Country Reporting
CFA	Committee on Fiscal Affairs
CFC	Controlled Foreign Companies
CIT	Corporate Income Tax
DTC	Double Taxation Convention
EC	European Commission
EU	European Union
GAAP	Generally Accepted Accounting Principles
GAAR	General Anti-Avoidance Rules
HMA’s	Hybrid Mismatch Arrangements
IFRS	International Financial Reporting Standards
MLI	Multilateral Instrument
MNE’s	Multinational Enterprises
MS(s)	Member State(s)
NL	The Netherlands
OECD	Organization for Economic Cooperation and Development
OECD MC	Organization for Economic Cooperation and Development Model Convention
PE	Permanent Establishment
PSD	Parent Subsidiary Directive
SAAR	Specific Anti-Avoidance Rules
TFEU	Treaty on the Functioning of the EU
WHT	Withholding tax

Chapter 1. Introduction

1.1 Motivation of the research

In recent years, the media reported that US multinationals pay almost no corporate income tax through tax avoidance schemes. Like Google and Apple who paid an effective tax rate below 5% on their foreign income[1]. According to the reporting news, their strategy was to make advantage of loopholes and differences (disparities) between tax laws of states by shifting profits to low- or no tax jurisdictions. This gave rise to public discussions concerning profit shifting and tax avoidance of MNEs. From the intense international debate it followed that society and other considered interested parties believed that MNEs are not paying their fair share of taxes to society[2].

Why is tax avoidance being a huge problem? Despite that MNEs are acting within the letter of the (tax) law to attain beneficial tax treatment, the issue is that it undermines the moral acceptance[3]. It is not in line with the public understanding playing fair by the rules. Ultimately, the tax burden would be passed on to citizens, for instance.

The type of tax planning adopted by said MNEs is possible because tax laws of countries are not sufficiently aligned allowing MNEs to make use of mismatch structures. In cross border situations a financial instrument or an entity is treated differently in one state or the other for tax purposes resulting in a beneficial treatment[4]. Consequently, the effect is double non-taxation which leads to substantial erosion of the tax base in countries. Many countries, already, faced losses of approximately USD 100 to 240 Billion of their tax revenues[5].

As a response, in the wake of the global financial crisis that started 2008, the OECD made Base Erosion and Profit Shifting a main priority on their political agenda. In 2013 with the support of the G20 countries a two-year BEPS project was launched and the reports were published in 2015 with 15 actions aimed at putting an end to tax evasion and avoidance through aggressive tax planning. One of these actions is action 2, *Neutralise the Effects of Hybrid Mismatch Arrangements*, consists of recommendations which set out how to shape the domestic law and the OECD Model Tax Convention in order to combat the substantial erosion of the taxable base caused by hybrid mismatches. The guiding principle is that profits should be taxed where economic activities take place and where value is created. This could be most effectively achieved both by applying the BEPS-measures and the co-ordination in the implementation of the rules by States, since unilateral rules could result in an inconsistent outcome generating a mismatch. Also, within the EU the same issue persisted.

Since the European MSs are sovereign, their national tax law differ. This resulted in disparities between the MSs albeit in accordance with case laws of the European Court and EU Law which affected the level playing field[6]. The main dilemma was that within the internal market disparities may arise due to qualification differences of an instrument or an entity which is transparent in one state and non-transparent in another state. This resulted in different tax outcomes where an item of income was

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[1] International Company Taxation and Tax Planning, Dieter Endres & Christoph Spengel, p. 514, effective tax rate reported in 2010.
[2] S.A. Stevens, Article: The Duty of Countries and Enterprises to Pay Their Fair Share, Tijdschrift voor Fiscaal ondernemingsrecht.
[3] J.L.M. Gribnau and A.G. Jallai, Good Tax Governance and Transparency, A matter of Ethical Motivation, Tilburg Law School Legal Studies Research Paper Series.
[4] Briefing EU legislation in Progress, Hybrid Mismatches wit Third countries, Opinion of the European Parliament of 27 April 2017.
[5] OESO/G20 Base Erosion and Profit Shifting Project, “Neutralising the effects of hybrid mismatch Arrangements”, Action 2: 2015 Final report.
[6] Paragraph 1 and 27, Preamble ATAD 2.

deducted twice (DD) or deducted and not included (D/NI) in the income in cross-border situations. MNEs are using tax strategy for such tax outcomes to achieve double non-taxation. But how should this be solved in the absence of harmonization? Unlike indirect taxation, on European level direct taxation is not harmonized yet. All the more reason that there is a high need to boost tax transparency and more fairness in the internal market to deal with hybrid mismatches in the EU[7]. While the BEPS Project started, the code of conduct group[8] was already fighting tax avoidance, inter alia, tackling international hybrid mismatches and disclosure requirements of aggressive tax planning schemes.

Hence, more or less simultaneously with the OECD BEPS, the EC took a parallel move and presented in the first quarter of 2015 the 'Tax Transparency Package'. This was the first step to create more openness and cooperation between the Member States on corporate tax issues. Unlike the OECD, the EC wanted to take real actions which resulted in the Anti-Tax Avoidance Directive 1[9] (ATAD 1, EU Directive 2016/1164) on 12 July 2016 to be implemented in the MS domestic legislation. The issue that ATAD 1 tackled was confronting purely hybrid mismatches within the EU. This Directive has an implementation date on December 31, 2018, at the latest.

However, it could not prevent multinationals taking advantage of disparities[10] still, particularly involving hybrid mismatches with third countries[11]. For this reason, the EU Council requested the EC during the ECOFIN Council, when ATAD 1 was adopted, to come up with a proposal on hybrid mismatches in relation with third countries and rules '*with and no less effective than the rules recommended by the OECD report on Neutralizing the Effects of Hybrid Mismatch Arrangements',* Action 2[12].

Consequently, after the agreement between EU Member States during the ECOFIN Council on 21 February 2017, the Amendment of EU Directive 2016/1164, ATAD 2 (EU Directive 2017/952), was formally adopted on 29 May 2017. The principles of ATAD 2, through coordination, are tackling the remaining hybrid mismatches also in relation with third countries. This way, one strong internal market will be achieved within the EU[13].

Particularly, the proposal for ATAD 2 was welcomed with far less enthusiasm by the Dutch governance in first instance because this would prevent them to invest in the Netherlands. Actually, many US MNEs had organized their European operations via the Netherlands using hybrid entities such as the CV/BV, in creating more jobs which is good for the Dutch economy.

Recently, on 1 January 2019, the measures of ATAD 1 were implemented and entered into force, whereas ATAD 2 need to be transposed into national law before 1 January 2020. By exception, the anti-hybrid measure regarding reverse hybrids in relation with third countries requires to be implemented before 1 January 2022.

The question now is whether the ATAD 2 measures are effective means to tackle the OECD BEPS identified mismatches through the use of hybrid mismatch arrangements under the United States and the Dutch tax treaty involving CV/BV structures.

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[7] https://ec.europa.eu/commission/news.
[8] Martijn F. Nouwen, "The European Code of Conduct Group Becomes Increasingly Important in the Fight Against Tax Avoidance: More Openness and Transparency is Necessary", Intertax .
[9] Paragraph 3, Preamble ATAD 2. Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market was included.
[10] Paragraph 7, Preamble ATAD 2.
[11] G.K. Fibbe & A.J.A. Stevens, Hybrid mismatches under the ATAD I and ATAD II, EC Tax Review 2017-3.
[12] Paragraph 5, Preamble ATAD 2.
[13] EU Direct Tax Newsalert, ATAD 2 Directive formally adopted, 29 May 2017.

1.2 Problem statement and Research question

The OECD BEPS Project action 2, *Neutralise the Effects of Hybrid Mismatch Arrangements,* as a starting point on international level has led to the adoption of Anti-Tax Avoidance Directive 1 and 2 in an European context. Since examining the BEPS Project and both the Directives concerning Hybrids is too broad, I will narrow down my research to the effectiveness of hybrid mismatches in ATAD 1 and 2 in relation with Action 2 of the OECD BEPS Project. The focus is on the impact of this in the Netherlands, in particular regarding reverse hybrid entities. The first Directive has been implemented in Dutch law since 1 January 2019 and it remains to be seen whether these measures are implemented effectively and have a desirable impact in this State. For this reason, the research question of this Master thesis reads as follows:

"Does the proposed implementation of the anti-hybrid mismatch measure under ATAD 1 and 2 by the Netherlands solve the issue of reverse hybrid mismatches between the Netherlands and the United States legitimately and adequately?"

To examine whether this measure provides a suitable solution tackling hybrids effectively, the following sub-research questions pop up.

- *What are hybrid mismatches and what are the issues that arises accordingly?*
- *What type of hybrid mismatches are identified under OECD BEPS Action 2?*
- *What kind of measures regarding hybrids have been taken under ATAD compared to OECD?*
- *How does the Netherlands plan to implement the anti-hybrid measure of ATAD 2?*
- *Does the anti-hybrid measure of ATAD 2 has the desirable effect?*
- *What are the alternatives in response of the ATAD 2 measures?*

The core of this research is the effect of the implemented anti avoidance measure of (reverse) hybrid entities in the Netherlands in relation with the US, in particularly CV/BV structures.

1.3 Delimitation

This thesis discusses and examines hybrid entities, in particular reverse hybrid entities where possible. The most common mismatches regarding hybrid mismatch arrangements, further HMA, in the BEPS Project Action 2 will be mentioned shortly. As the solutions provided for by ATAD 2 would impact current CV/BV situations, from a Dutch view, the provision concerning reverse hybrid mismatches will be elaborated and the impact of Double Taxation Convention (DTC) in this respect is also relevant.

1.4 Methodology and outline

Referring to the underlying research question, the efficiency and the legitimacy of the anti-hybrid measures under ATAD and BEPS Project Action 2 will be analyzed based on the supporting documents and existing literature. In this respect the doctrinal research method (legislation, doctrines, case laws, treaties, rules, literature, electronic resources, and governmental publications etc.) will be applied together with the political view of the governments, other scholars and my own view.

As a follow-up, in *chapter 2* the problem of base erosion and profit shifting (further BEPS) is identified, and the recommendations regarding the regular and the reverse hybrid entities of BEPS Action 2 are dealt with. The aforementioned is compared to the ATAD where both hybrid entities are elaborated and how the amended ATAD has been changed against ATAD 1 *(chapter 3)*. Further, ATAD 2 anti-reverse hybrid measures in the Netherlands will be discussed in relation with the US and other relevant measures *(chapter 4)*. Finally, *chapter 5* the alternatives for HMA's are presented and the conclusion (*chapter 6*).

Chapter 2. Base Erosion and profit shifting

The first step towards better understanding of the effectiveness of the mechanisms laid down in the Directives [ATAD 1 and 2] is to identify the problem of base erosion and profit shifting as described in the OECD BEPS Action 2 and the issues that arises accordingly. This chapter will provide first briefly the problem definition of BEPS and the OECD approach on this matter (*2.1*); in section (*2.2*), an analysis of BEPS Action 2 and its delimitation is outlined; and, further in section (*2.3*) the specific measures against regular and reverse hybrid entities and its solutions are discussed. In the last section (*2.4*), some additionally remarks are made regarding BEPS Action 2 with my own view. A critical approach of the true efficacy of the proposed solutions will not be avoided.

2.1 The BEPS-problem

BEPS is not a new substantial phenomenon according to the OECD[14]. It refers to tax planning strategies used by MNEs to exploit gaps and mismatches in tax rules of different States[15]. Individual states apply their own domestic tax rules and different interpretation from other states which leads to tax arbitrage. The MNEs are lowering the overall tax burden by shifting their profits to low or no tax locations where there are no real business activities. As a result, the tax base of the entity gets eroded where profits are actually created and where value is added. The inefficient allocation of resources is perceived abusive and this arbitrage leads to double non-taxation, i.e. that cross-border activities are taxed much lower compared to purely domestic situations. Such tax driven investments affect the fairness and the integrity of the tax system[16]. Moreover, it will possible undermine voluntary compliance by other taxpayers if they believe that multinationals are legally avoiding paying income tax[17]. In fact, that MNEs are legally maximizing their tax advantages is objected by the public.

BEPS became an issue due to increased cross-border transactions by MNEs and globalization[18]. The BEPS-problem lies in the tax rules themselves and governments are responsible to come up with another approach. It is in their own political interest to tackle those aggressive practices. Existing studies have shown that BEPS is widespread and that tax revenues are at risk. There is no comprehensive data available in relation to the collective tax revenue loss, yet it is evidenced that the amounts in individual cases are substantial[19].

Another issue is the mutual competition among States with their "race to the bottom" driving tax rates of certain sources of income to zero in order to attract foreign investors and revenue. In fact, governments are thoughtfully accepting BEPS. This is perceived harmful by the OECD and does not create a level playing field for all tax payers[20].

In response to this, the OECD concluded in 2015, after their two years BEPS Project, 15 Actions based on coherence, substance and transparency to pursue two objectives[21]. Avoiding double taxation without giving rise to double non-taxation, and to establish domestic and international mechanisms focussing on better aligning taxing rights with real economic activity. Strategically, this could be achieved by (1)

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[14] *http://scholarship.law.ufl.edu/facultypub/642,* Brauner Yariv, What the BEPS, 16 Fla. Tax Rev. 55 (2014), p. 57-58. (hereinafter Brauner).

[15] http://www.oecd.org/ctp/BEPS-FAQsEnglish.pdf , OECD 'BEPS: Frequently Asked Questions', accessed 19 February 2019.

[16] OECD/G20 Base Erosion and Profit Shifting Project, 2015 Final Reports.

[17] OECD, Addressing Base Erosion and Profit Shifting (2013), p. 8.

[18] Some tax schemes are illegal and tax administrations are fighting them, 'BEPS: Frequently Asked Questions'.

[19] OECD (2012), Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, OECD, Paris (the '2012 OECD Hybrids Report); Brauner, p.60, although the magnitude of BEPS is relatively small, it is significantly enough to trigger action.

[20] Supra 15, OECD 'BEPS: Frequently Asked Questions'; Brauner, p. 60.

[21] Brauner, p. 58.

replacing a competition-based mindset with a collaborative-based one; (2) taking a holistic approach rather than ad hoc measures; and (3) developing completely new solutions that could not be resolved by the applicable rules such as the traditional conservatism of international taxation. This ambitious spirit ensures that profits are taxed where economic activities are carried out and value is created.

However, there have been multiple debates regarding the BEPS initiative which raised some doubts[22]. Are taxpayers unduly held responsible by the discourse of the media and by governments for the outdated rules from the early 20th century instead of accepting the obvious crisis of rules? Initially, the BEPS Report shared this view, yet deviated from it. It inappropriately and inaccurately referred to 'artificially' or 'abuse' without a legal basis, and concluded inevitably the presence of aggressive tax planning. Regardless of the legal uncertainty, it is not fair as taxpayers who are tangentially linked to companies ultimately bare the tax burden to simply enforce them with moral behaviour[23]. Instead, the OECD should rather revise the legal framework with an innovative and holistic approach genuinely [24]. Not to focus mainly on the tax behaviour of MNEs.

Similarly, due to growing disinterest of the OECD and governments and the tight timeline, the Action Plan failed to deliver completely new measures. Most of the Actions[25] are based on pre-existing commentaries to the OECD MC which are the outcomes of the old OECD Reports.

2.2 Hybrid mismatch Arrangements covered by the OECD BEPS Project, Action 2

BEPS Action 2 belongs to the group 'true' Action items which resembled the core of the BEPS-strategy, ensuring that "*profits are taxed where the economic activities generating the profits are performed and where value is created*"[26]. These new measures designed to establish international coherence in corporate income taxation[27] would contribute therein.

For this purpose, the OECD produced a set of recommendations in the form of specific rules which States could implement in their domestic laws and in their tax treaties[28]. It recommends improvements to domestic laws in light of better alignment between those laws and their intended tax outcomes[29].

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[22] Eva Escribano, 'Is the OECD/G20 BEPS Initiative Heading in the Right Direction? Some Forgotten (and Uncomfortable) Questions' (2017), Bulleting for International Taxation, p. 250-253, (Escribano). Three different groups of taxpayers are identified:1) the *shareholder* as a result of a decrease in the invested capital; 2) *employees* by reduction in their payment; and 3) *consumers* due to increase in the price.
[23] Escribano, *supra 23*.
[24] Ibid, This includes ignoring the distribution of tax jurisdiction between residence and source, yet aims at restoring taxation on both levels; the *separate entity approach* (separate tax treatment of entities within the same group) and the *arm's length principle* (the determined price between related parties should be similar and under the same conditions as if they were unrelated).
[25] Ibid, Actions 2, 5, 6, 7, and 12 are based on "old" reports, whereas Actions 1, 13, and 15 are a few innovative standards with a global view.
[26] OECD (2015), Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publ., p. 3.
[27] OECD 2013, *Action Plan on Base Erosion and Profit Shifting*, OECD Publ., p. 15.
[28] The OECD report is divided into two parts, part I regarding recommendations for domestic law and part II recommendations for tax treaties. 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. 11-12.
[29] OECD (2015), p. 18. Chapters 2 and 5: *(a) Deny a dividend exemption, or equivalent relief from economic double taxation, in respect of deductible payments made under financial instruments. (b) Introduce measures to prevent hybrid transfers being used to duplicate credits for taxes withheld at source. (c) Alter the effect of CFC and other offshore investment regimes to bring the income of hybrid entities within the charge to taxation under the laws of the investor jurisdiction. (d) Encourage countries to adopt appropriate information reporting and filing requirements in respect of tax transparent entities established within their jurisdiction. (e) Restrict the tax transparency of reverse hybrids that are members of a control group*.

Accordingly, the so-called coordinated ‘linking rules’ adapt the tax treatment of one State with the tax treatment of the other State due to qualification and classification differences. In this manner, no mismatches will arise by the lack of coordination between the countries involved. Apparently, the OECD aims at neutralizing the mismatch outcomes of the HMAs with those rules, instead of resolving the problems at its cause.

Nevertheless, coordination is crucial. By bridging the ‘gaps’ between the rules of States the single tax principle[30] will be enforced since unilateral action cannot do that. Further, in practice there are many challenges in relation with HMA to handle. The classification of entities, such as treatment of partnerships under a tax treaty is one of them. The various challenges could be decreased through cooperation. And, since many countries are involved, within a short term that is not likely to occur since their revenue is at stake[31].

Action 2 did not address those challenges but rather focused at technical details. It suggested the most obvious mismatch rules which are mainly based on payments under a HMA with three different tax outcomes: (a) deduction in the payer’s State which is not included in the income of the recipient and thus not taxable, the other State *(deduction/no inclusion or ‘D/NI’ outcomes)*; (b) deductions for the same amount of expenditures in both States *(double deduction or ‘DD’ outcome)*; and (c) payments that are deductible in one jurisdiction which are set-off by the payee against a deduction under a hybrid mismatch arrangement *(‘indirect D/NI’ outcome or indirect deduction/ no inclusion)* [32].

Although no exact definition[33] is provided in Action 2, hybrid mismatches are defined as arrangements exploiting differences in tax treatment of entities, instruments, dual resident entities or transfers under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral.

As stated before, the recommendations specified in the Action 2 Report are not novel[34]. In particular, the proposed changes to Article 1.2 in respect with the application of tax treaty to entities that are regarded as transparent for tax purposes[35]. Other entity issues are the classification and tax treatment of other transparent and hybrid entities, and the check-the-box regime ("CTB") of the United States permitting at-will elective changes of entity classification[36]. Challenges concerning hybrid instruments, such as derivative financial instruments, classification of potential hybrid transactions, permanent establishments, and mismatches due to dual residency will be out of scope of this thesis.

2.2.1 Delimitation of BEPS Action 2

To avert complexity in the application and administration of the linking rules and to achieve an overall balance, each hybrid mismatch rule has its own defined scope[37]. In the context of this thesis, the scope of two types of hybrid entity mismatches, the regular and the reverse hybrid entities, are presented hereafter.

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[30] Income should be taxed no more or less than once.
[31] Brauner, p. 82-83.
[32] OECD (2015), supra 26, p. 16-17.
[33] Ibid.
[34] Ibid, p. 15, par. 2, The Hybrids Report (2012) already noted that such rules are not a novelty as, in principle, foreign tax credit rules, subject to tax clauses and controlled foreign company (CFC) rules often do exactly that.
[35] Brauner, p. 82.
[36] See OECD, *The application of the OECD Model Tax Convention to Partnerships*, No. 6 1999.
[37] OECD (2015), par. 16, p. 18-19.

Generally, a *regular hybrid entity* is an entity regarded as taxable or opaque in the state of incorporation, whereas in the investor state the same entity (foreign entity) is classified as fiscally or tax transparent[38]. Shortly, implying that investors in the latter country are taxed rather than the entity. A *reverse hybrid entity*, however, is the opposite situation. The state of incorporation considers the entity as transparent and the state of the investor, or resident state, considers opaque. Both types of mismatches are a result of *classification differences in two jurisdictions of the same entity*.

BEPS Action 2 limits its scope regarding (I) *payments to a disregarded entity*, (II) *payments to a reverse hybrid entity* and (III) *payments made by a hybrid entity* to members of the same control group and structured arrangements[39]. Those three structures will be further outlined in sections *2.3.1, 2.3.2* and *2.3.3.*

According to Recommendation 11, two persons are in the *same control group* if[40]: (i) *both are consolidated for accounting purposes*. The subsidiary is required to be consolidated, on a line-by-line basis in the parent's consolidated financial statements (IFRS or GAAP)[41]*; (ii) the first person effectively controls the second person or there is a third person with an effective control over both* (i.e. sufficiently significant investment in both)[42]*; (iii) the first person holds at least a 50% investment in the second person or there is a third person that holds at least a 50% investment in both*[43]*; (iiii) they can be regarded as associated enterprises under Article 9*[44]. For the investor, the payer and intermediary in the same group knowledge about the hybrid element between the parties is implied since determining the other parties' tax treatment on the same payment may not be difficult[45].

Further, Recommendation 10[46] defines a structured arrangement as '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'. Regardless of the parties' intentions, this arrangement has to be observed objectively and should point out whether the mismatch was a feature of this structure[47]. Accordingly, a person who is a part of this structured arrangement must have a *sufficient level of involvement* in the arrangement and is aware of the structure and its tax effect[48].

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[38] Leopolda Parada, Intertax Volume 46, Issue 12, *Hybrid Entity Mismatches and the International trend of matching tax outcomes: A crotical approach*, p. 973.
[39] Intertax, Volume 43, Issue 1, BEPS Action 2: *Neutralizing the effects of Hybrid Mismatch Arrangements*, Reinout De Boer & Otto Marres, For other DD mismatches, there is no restriction in the personal scope (except to the defensive rule – deny payer deduction- in respect of payments made by a hybrid entity. Also, OECD (2015), Recommendation 11, par. 348, p. 114.
[40] OECD (2015), Recommendation 11, p. 113.
[41] Ibid, par. 363 p. 116.
[42] Ibid, par. 364 p. 116.
[43] Ibid, par. 365 p. 116.
[44] Ibid, par. 366 p. 116. According to *Article 9.1 "associated enterprises"* are found where: (a) An enterprise of a Contracting State participates *directly or indirectly* in the management, control or capital of an enterprise of the other Contracting State, or (b) 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.
[45] Reinout De Boer, p. 19.
[46] Ibid, Recommendation 10.1, p. 105.
[47] Ibid, par. 319, p. 106.
[48] Ibid, par. 320 (p. 106) and 342 (p. 110).

2.3 Hybrid Entity Mismatches

The OECD initially examined the treatment of transparent entities extensively in The Partnership Report (1999) involving issues arising from qualification conflicts in cases where treaty partners interpret the treaty in different ways[49]. This Report, however, was not focussed on abusive practices like BEPS Action 2, instead considered the mismatches as a result of unbalanced taxation due to difficulties combining different autonomous tax regimes which required to be tailored. Besides, the report was devoted to entities classified as partnerships, BEPS Action 2 had enlarged this to hybrids and transparent entities[50]. Therefore, Action 2 suggested to add a provision to the OECD MC ensuring that these benefits are not granted where neither Contracting States treat, under its domestic tax law, the income of an entity or arrangement as the income of one of its residents[51].

In the following sections, the hybrid entities with D/NI and DD outcomes and the reverse hybrid entity (D/NI) will be shortly described, including the solutions as proposed by Action 2.

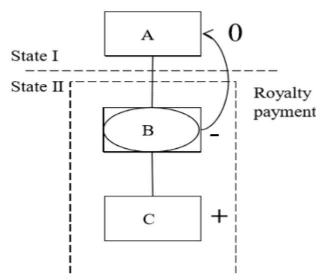
2.3.1 Hybrid entities with disregarded payments (D/NI outcome)

2.3.1.1 Recommendation 3 (chapter 3)

A disregarded payment is a payment which is deductible under the tax law of the payer jurisdiction and is not recognized under the law of the payee jurisdiction which results in a D/NI outcome[52]. The deduction may be set off against income which is not included in both jurisdictions (dual inclusion income) [53]. Above all, the payer is actually entitled to this deduction under its domestic law. Conditionally, that other transaction or specific entity rules preventing deduction are not applicable[54].

2.3.1.2 Primary and secondary rule

The primary rule recommends the payer jurisdiction to deny a deduction of such payment, if not, the payee state need to implement a defensive rule. Accordingly, the same amount of deduction will be recognised as ordinary income in the recipient state[55]. This way, the mismatch with a D/NI outcome within a controlled group or due to a structured arrangement will be neutralised.



[49] The Application of the OECD Model Tax Convention to Partnerships (1999), par. 1 and 3 p. 7. The main conclusions have been included in the Commentary of the OECD Model Tax Convention (OECD, 2014), Also OECD (2015), par. 434-435 p. 139.
[50] Bart Peeters, Hybrid mismatches: From inspired Coordination to mere Anti-Abuse, 2017 Tax Magazine 186 (2017), p. 7.
[51] OECD (2015), par. 435 p. 139, adding paragraph 2 to Article 1 OECD MC and par. 26.3 – 26.16 to the Commentary on this Article, also p. 140 par. 26.6.
[52] *Ibid*, Recommendation 3 p. 49, also par. 132 p. 53. Also, for this section the payee state and the recipient state is regarded the same.
[53] *Ibid*, p. 49 and par. 125 p. 51.
[54] *Ibid*, par. 122 p. 51, an example of specific entity rules is the hybrid financial instrument rule, Recommendations 1 and 2.
[55] *Ibid*, Recommendation 3 p. 49, also par. 128 p. 52.

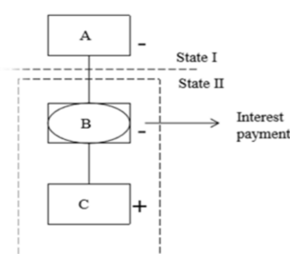
2.3.2 Payments made by a Hybrid Entity (DD outcome)

2.3.2.1 Recommendation 6

The subsequent recommendation (6) should be followed regarding a payment which is deductible in the payer state and triggers a duplicate deduction in the parent jurisdiction[56]. A comparison should be made between the laws of both jurisdictions to determine the deductibility of the payment. The mismatch with DD outcome arises from the fact that the payer state regards the entity as opaque and, this entity is eligible for such deduction. On the other hand, the parent jurisdiction treats the entity as transparent so the payment occurs at the level of the investor(s). Yet, no mismatch will occur if the deduction is being set-off against dual inclusion income[57]. Equally, as section *2.3.1.1* noted, mismatches should be neutralised to the extent the deduction is not subjected to other transaction or specific entity rules[58].

2.3.2.2 Primary and secondary rule

The primary rule applies in the parent jurisdiction where the mismatch gives rise to a double deduction. The adjustment should be no more than necessary and proportionate to prevent double taxation. This means that, the amount of duplicate deductions is restricted to the total amount of dual inclusion income. In this respect, there is no limitation on the scope of the primary response. The payer state, if the primary rule is not applied or not neutralized, rejects the deduction with the secondary rule for parties in the same control group or structured arrangement to neutralise the hybrid mismatch[59]. In the latter situation, the rule may deny an excess amount of deduction what otherwise may not be denied in the parent jurisdiction for the same payment[60].



2.3.3 Reverse Hybrid Entity (D/NI outcome)

2.3.3.1 Recommendation 4

This recommendation applies to payments made to a reverse hybrid and that the mismatch would not have incurred if it had been paid directly to the investor[61]. A reverse hybrid mismatch arises if the state where

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[56] *Ibid*, Recommendation 6 p. 67, also par. 189 and 211, resp. p. 69 and 74, also the parent state and the investor's state is the same in this context.

[57] *Ibid*, Recommendation 6 p. 67, also par. 181 and 197, resp. p. 68 and 71. A mismatch with a DD outcome still occurs to the extent the deduction exceeds the dual inclusion income, i.e income included in both jurisdictions, which is attributable to the hybrid entity. The exceeded deduction, accordingly, will be neutralized with the linking rules.

[58] *Ibid*, par. 181 p. 68, *supra 53*: hybrid financial instrument rule, Recommendations 1 and 2, also par. 190 p. 70.

[59] *Ibid*, par. 183 p. 68, also par 186 p. 69.

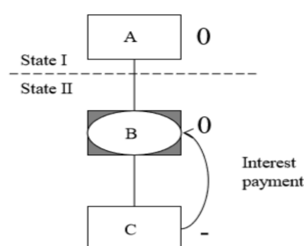
[60] *Ibid*, par. 200 p. 72, Example 6.5: the *full amount of the deduction* of the interest payment under defensive rule should be denied to neutralize the mismatch, even when merely *a portion of the interest* causes a double deduction in de investor's state.

[61] *Ibid*, par. 139 p. 55, also par 141: *a reverse hybrid entity may be inserted in a structure to avoid the primary rule of recommendation 1, the hybrid financial instrument rule. To prevent such structure, the reverse hybrid rule is also applicable to the extent a direct payment have been subject to adjustment under the primary rule of recommendation 1.*

the participants (investors) arise considers the entity to be non-transparent, whereas the other state, the state where the entity resides, treats the entity as transparent [both the payer and the payee could be in the same state]. In the latter state, any payment of the profits allocated by the entity to the investors, residents of the other state, will not be taxed. The investor state regards this entity as non-transparent, and accordingly, does not recognize the payment as taxable income in its jurisdiction. As a result, that the payment to a reverse hybrid entity may be deductible, whereas the income is not included in any tax base. This way, the state of establishment and the state of the investors are not taxing the income. Essential is that, the moment of payment is relevant for such a mismatch, whether the future distributions to the investor will be taxed or not are not at issue[62].

2.3.3.2 Primary and secondary rule

This recommendation solely provides the primary rule which includes denying the payer a deduction in respect of payments made to the reverse hybrid. No secondary rule is given in Action 2[63]. The rationale is that the specific recommendations in chapter 5 provide solutions which makes a defensive rule unnecessary, such as CFC rules and other offshore investment regimes, or transparency regimes taxing the payment in the establishment state as if it had been directly paid to the investor against its marginal tax rate[64].



2.3.3.3 Specific recommendations related to Reverse Hybrids (Recommendation 5)

Chapter 5 of Action 2 adopted specific recommendations which are not hybrid mismatch rules, suggest to enhance domestic laws in order to reduce the frequency of reverse hybrid entities. In this manner, the policy outcomes would be in line with rules in respect of taxing payments between domestic taxpayers[65]. Accordingly, three recommendations are inserted in this chapter[66].

Recommendation 5.1 suggests to include the share of payment allocated to the investor through a reverse hybrid in its income by improving CFC or other anti-deferral rules in the investor jurisdiction. This allocated payment will be included to the income of the investor. This would have the effect of neutralizing any hybrid mismatch under a payment to a transparent entity. Hence, the primary rule of the reverse hybrid mismatch rule is dispensable[67]. The anti-deferral rules could be combined with other possible measures, such as changes in the residency rules or taxing the variations in the market value of the investment.

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[62] *Ibid*, par. 156 p. 59.
[63] *Ibid*, par. 144 p. 56.
[64] *Ibid*, par. 161 - 162 p. 56. The hybrid entity is not regarded as transparent and is tax liable on behalf of the investor in the other state.
[65] *Ibid*, par. 169 - 170 p. 63.
[66] *Ibid*, par. 171 - 179 p. 64 - 65.
[67] *Ibid*, par. 171 - 173 p. 64.

In addition, *recommendation 5.2* encourages the state of establishment to turn off their tax transparency rules as if the entity is a resident taxpayer. Any part of income allocated to the non-resident investor, distributed or not, will be taxed on the level of the reverse hybrid entity. The investor jurisdiction could provide a credit for the taxes paid in the establishment jurisdiction caused by simultaneously using recommendations 5.1 and 5.2[68]. In this light, *recommendation 5.3* stimulates tax authorities to maintain appropriate reporting and filing requirements for tax transparent entities that are established within their jurisdiction[69].

2.4 Some final remarks

The bottom line of this chapter is that stakes are high to all parties involved as regards solving BEPS. The complex approach of the BEPS Action Plan seems questionable.

It occurred to me that, even though Action 2 tried to avoid double non-taxation with its solutions, it deviated partly from is objective. Initially, the purpose was aligning the taxing rights with the place where economic activities takes place and value is created based on the *origin principle*. Instead, the OECD preferred to tax the income from the hybrid structure at least once [*the single tax principle*], irrespective where, and what the parties intentions are. This appears also with the proposed linking rules. The primary rule must be applied in all cases, the secondary rule, however, only if the primary rule was not invoked. In this case, income should be taxed at least once either and deduction is only granted once. In doing so, the OECD does not bother which country lost tax revenue and which not.

Another doubt, are the provided solutions for hybrid structures with a D/NI or DD outcome which seems more complex than reflected in BEPS Action 2. If not all states are adopting this non-binding recommendations, they cease to have effect. Especially, if applied uniformly by some states. Probably, the MNEs would move their activities to jurisdictions which are more beneficial to continue their abusive hybrid practices. In my view, on a multilateral and binding basis the recommendations would have more effect to combat abusive practices. Otherwise, arbitrage opportunities may still exist.

From my perspective, the interplay with other anti-base erosion rules will make it not much simpler, such as CFC rules. A practical and logical reaction would be to prioritize the CFC rules in order not to enforce the difficult anti-hybrid mismatch rules.

Finally, as evidenced, the core problem of the entity mismatches were disregarded. The OECD should have addressed its cause for a much better solution. From my perception, the basic should be avoiding non-taxation and from there adopting rules to characterize the diverse interpretation of hybrid entities among states with a multilateral coordinated approach. The transparency of the entity would be turned off, or treated equally, in different states and the allocated income is taxed accordingly. This is the same as the specific recommendations of Action 2.

Indeed, since this research is not that extensive my view may be straightforward. Is BEPS Action 2 heading the right path with effectively tackling abusive HMAs? Will states change their conservatism attitude with a small chance to a political agreement? Still, many questions remains unanswered. For now, the proposed solutions of matching the tax outcomes looks like the most suitable one.

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[68] *Ibid*, par. 174 - 175 p. 64 – 65.
[69] *Ibid*, par. 176 - 179 p. 65.

Chapter 3. The European perspective: the Anti-Tax Avoiding Directives (ATAD 1 and 2)

3.1 The development of the Directives

After the completion of the OECD BEPS Action Plan for combatting tax avoidance, the EC presented in January 2016 its proposal for an Anti-Tax Avoidance Directive which was a part of the ATAP[70]. The proposed measures of ATAD are not novel and originate from the international anti-BEPS aspects[71] of the CCCTB proposal. Accepted by the Council on 17 June 2016, its aim was fighting corporate tax abuse in a coordinated and coherent manner at European level[72]. By means of legally binding rules mismatches with a DD and D/NI outcome which directly affected the functioning of the internal market[73] were tackled. The rules are principle-based and create a minimum protection[74] to the corporate tax base of the MS. The detailed implementation was left to the MS.

A setback was that it only covered cross-border structures within the EU, allowing HMA involving third countries still resulting mismatch opportunities. In addition, a few HMA symptoms were recorded and other undesirable structures, such as hybrid permanent establishment mismatches and dual resident mismatches, were excluded from Article 9 of ATAD 1[75]. On the other hand, the proposal of the ATAD 1 tempted first to eliminate the cause by accepting the tax classification of the other MS in case of (partial) double non-taxation in the EU. Regretfully, this measure was abandoned. Originally, the whole point was that the Directive as a 'preferred vehicle'[76] would *implement the conclusions of BEPS Action 2 within Union law* being effective. This Action, however, was not exhaustively adopted in ATAD 1[77].

Therefore, on request of the ECOFIN Council in July 2016, the EC came with a proposal on 25 October 2016 regarding hybrid mismatches involving third countries, including reverse hybrid entities. A comprehensive framework countering HMAs was provided with rules *consistent with and no less effective than the recommendations of the OECD BEPS Action 2*. Hence, it extended the geographical scope and added some HMAs that were missing in ATAD 1. In fact, situations with double taxation and hybrid mismatches with individuals were not addressed[78]. Nevertheless, The proposal was approved in May 2017 by the European Council[79].

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[70] https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en, This package included inter alia (1) *Revision of the Administrative Cooperation Directive* (CBC Reporting); (2) *Recommendations on Tax Treaties* (GAAR); (3) *Communication on an External Strategy for Effective Taxation*.

[71] Aloys Rigaut, Anti-Tax Avoidance Directive (2016/1164): New EU policy horizons, European Taxation IBFD, p. 498. The seven international anti-BEPS aspects of the CCCTB proposal are (1) the PE definition; (2) the CFC rules; (3) the Switch-over clause: (4) the GAAR; (6) the Interest Limitation rules; and (7) rules regarding hybrid mismatches.

[72] EC (2016), *Proposal for a Council Directive laying down rules against tax avoidance practices that directly affects the functioning of the internal market*, 28-01-2016 COM(2016), 26 Final (2016/0011), p. 3-5.

[73] EC (2016), 26 Final (2016/0011), *supra 72*, p. 3. Resulting in an unfair tax competition within the EU.

[74] The minimis application was inspired by the Parent-Subsidiary Directive with the minimis anti-abuse clause.

[75] EC (2016), *Proposal for a Council Directive amending Directive (EU) 2016/1164 as regards Hybrid mismatches with third countries*, 25-10-2016 COM(2016), 687 Final (2016/0339), Preamble inter alia par. 6 and 26.

[76] As ruled in the *Columbus Container Services* case, a Directive is the designated instrument to counter HMA's since obstacles caused by tax classification differences between MSs are beyond the scope of the fundamental rights and freedom of the EU. See *Columbus Container Services BVBA & Co. v. Finanzamt Bielefeld-Innenstadt*, CJEU 6 December 2007, Case C-298/05.

[77] Council Directive (EU) 2016/1164 of 12 July 2016 *Laying down rules against tax avoidance practices that directly affects the functioning of the internal market*, Preamble par. 2.

[78] EC Tax review 2017-3, GK Fibbe & AJA Stevens, *Hybrid mismatches under ATAD 1 and 2*, p. 153-154. On the contrary, The ATAD 1 stated in the Preamble par. 5 that besides its aim fighting tax avoiding is not creating other obstacles in the internal market, such as Double taxation. Tax payers should receive relief thereof through a deduction for the tax paid in the other MS or third country. This is missing in the Preamble of the ATAD 2.

[79] EC (2016), *Council Directive amending Directive (EU) 2016/1164 as regards Hybrid mismatches with third countries*, 12-05-2017 (2016/0339).

The intention of the Directives is not to affect the general features of the State's tax system, and, therefore, the Directives do not address situations where no or little tax have been paid due to the tax system[80].

In prior years, corporate taxation in the EU as hard law was limited to the Parent-Subsidiary-Directive[81], the Merger Directive[82], the Interest and Royalties Directive[83], the EU Recovery Directive[84], and the Directive on Administrative Cooperation in tax matters[85]. However, the amendment to the PSD Directive[86] created the first legal basis for the linking rules within the EU, though it did not solve situations beyond the EU[87].

The measures of ATAD 1 need to be implemented by the MS as from 1 January 2019, and the hybrid mismatch rules under ATAD 2 on 1 January 2020. The reverse hybrid entity rules are deferred till 1 January 2022. However, MSs are free to implement these before those dates.

Besides, other anti-avoidance rules laid down in the Directive are fighting common forms of abusive tax structures as well. Those are the CFC rule, rules regarding Exit taxation, the interest limitation rule and the GAAR. Where the rules of ATAD 1 are applicable, those of ATAD 2 are out of scope[88].

In this chapter only the measures from both ATAD 1 and 2 regarding hybrid mismatches caused by (reverse) hybrid entities will be discussed. The Directives will be compared to the conclusions of BEPS Action 2. Its pitfalls and improvements are analyzed in order to assess the effectiveness of the Directives. In fact, ATAD 2 amended ATAD 1 because the scope of the latter was considered not to be extensive enough with BEPS Action 2. This chapter will be finalized with an interim conclusion accompanied with my own view.

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[80] *Ibid,* p. 5.
[81] Council Directive 2011/96/EU of 30 November 2011 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, OJ L 345/8 (2011).
[82] Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, OJ L 225 (1990).
[83] Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Companies of Different Member States, OJ L157 (2003).
[84] Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures, OJ L84 (2010).
[85] Council Directive 2011/16/EU of 15 February 2011 on Administrative Cooperation in the Field of Taxation and Repealing Directive 77/799/ EEC (DAC), OJ L 64 (2011).
[86] Council Directive 2014/86/EU of 8 Jul. 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, OJ L219/40 (2014). The former Directive did not allowed that the Parent state denied a dividend exemption if the payer deducted the same item of income due to a mismatch in the characterization of the income.
[87] EC Tax review 2016-3, A. Navarro, Leopoldo Parada & Paloma Schwarz, *The proposal for an EU Anti-Tax Avoidance Directive: Some Preliminary Thoughts*, p. 128.
[88] EC (2016), ATAD 2, *Supra 79*, Preamble par. 30.

3.2. Anti-Tax Avoidance Directive 1

In response of the BEPS Project, the EU MSs want to implement the rules of ATAD 1. As such, the Directive provides limited rules solely with D/NI and DD outcomes caused by aggressive tax planning structures. In fact, it only focused on outcomes arising between EU MSs. So, the rules were not entirely in line with BEPS Action 2 Recommendations. Initially, the EU neutralises the effects of hybrid entity mismatches within the internal market. However, the rules are very technical in nature, i.e. that the outcomes are relevant and not the intention of the taxpayer.

3.2.1 Regular Hybrid Entity Mismatches

ATAD 1[89] excluded reverse hybrid entity mismatches and also non-EU situations fall outside its scope. Moreover, the Directive did not provide a definition regarding *'entities'*[90]. This appears in article 2(9) where the DD or DD/NI is attributable to the differences in the *legal characterization of entities*. And, the "*legal characterization"* is not clear either. Assuming, for the purpose of ATAD 1, the term is similar to "tax classification" which is very broad.

In this context, one may argue whether or not it is necessary that an entity should be established in a MS. This provision defines a *hybrid mismatch*, as a situation between a taxpayer in one MS and an associated enterprise in another MS or a structured arrangement between parties in MSs. The outcome can be a deduction of the same payment both in the MS where the payment has its source as in the other MS where it incurred (DD)[91]; or a deduction of the same payment in one MS (source state) without a corresponding inclusion in the other MS (D/NI)[92]. In addition, no definition is given to "has its source" which may lead to different interpretations between MSs upon implementation of this Directive.

Similarly, Preamble 4 confirms that the rules relates to all taxpayers that are subject to corporate tax in a MS. In addition, it states: *"Considering that it would result in the need to cover a broader range of national taxes, it is not desirable to extend the scope of this Directive to types of entities which are not subject to corporate tax in a Member State; that is, in particular, transparent entities..[...]"*. This implies that non-transparent entities, subject to CIT, are covered in ATAD 1, yet the reverse hybrid entities fall outside its scope. The latter are fiscally transparent in one of the MSs which are not subject to CIT.

Hybrid entity mismatch arrangements are addressed in Article 9 of ATAD and reads as follows:

1. *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.*
2. *To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.*

From this Article, it follows that the domestic laws of MSs need to be adjusted where the payment has its source and only within the EU. In this manner, the effects of hybrid mismatches are partly neutralized. Besides, the secondary rule as provided in BEPS Action 2 is missing in ATAD 1. In this respect, if one State would not apply the primary rule in paragraph 1 and 2 of this provision, the other State shall not be protected from one of the undesirable effects of HMA. Instead, MSs are obliged to allow deduction in the State where the payment is sourced (DD), and that the MS of the payer must deny the deduction (D/NI).

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[89] Council Directive (EU) 2016/1164 of 12 July 2016 *Laying down rules against tax avoidance practices that directly affects the functioning of the internal market*.
[90] EC Tax review 2017-3, supra 78, p. 160.
[91] *Ibid,* See article 2, par. 9, sub (a).
[92] *Ibid*, See article 2, par. 9, sub (b).

In addition, Article 2(9)(b) of ATAD 1 does not specify the outcome *without a corresponding inclusion* which could result in differing interpretations between MS's. The risk is that this could differ from the BEPS Action 2 interpretation[93].

Finally, ATAD 1 did not address the characterization or the differences of payments and restricted only to entities. This ignored a few mismatches covered in the OECD[94]. All in all, ATAD 1 does not effectively solve the issue of hybrid mismatches within the EU adequately and is not in line with BEPS Action 2 Recommendations. Therefore, a revised Directive was vital.

3.3. Anti-Tax Avoidance Directive 2

ATAD 1 was amended on request of the ECOFIN Council in July 2016. In ATAD 2, the scope was extended to hybrid mismatches involving third countries, including reverse hybrid entities. The rules were required to be no less effective than the recommendations provided in BEPS Action 2. Therefore, ATAD 2 also contains other hybrid mismatches such as imported mismatches, branch mismatches, tax residency mismatches and hybrid transfers. Still, it just applies to corporate taxpayers within the EU or reverse hybrid entities established in a MS[95].

Regarding the implementation of ATAD 2, the Netherlands had some reservations. Initially, it requested to postpone the implementation of the hybrid entity rules until 2024 due to the CV/BV structures. Such structures are mainly used by US MNEs taking advantage of mismatch differences between the Netherlands and the US. However, the proposal for deferral was denied by the Dutch Parliament. Instead, with the support of the majority of MSs the reverse hybrid entity provision[96] was adopted. According to this Article, hybrid entities should be considered as *taxable entities* in a MS if it is established or incorporated in a MS.

However, this is different from what is derived from preamble 28 of ATAD 2 which refers to the *BEPS Action 2 as a source of illustration or interpretation providing to be consistent with the provisions of ATAD 2 and EU law*. Due to this reference the Directive seems like having two approaches which creates more uncertainty. First, that profit should be taxed where value is created, and if not, than that profit should be taxed at least once[97].

3.3.1 Hybrid Entity Mismatches

The definition of hybrid entities in ATAD 1 was vague and could lead to different interpretations among MSs if implemented into national laws. For this reason, a new definition of *hybrid entity mismatches* were added to Article 2(9) of ATAD 2 regarding hybrid entities which involves:

(b) a payment to a hybrid entity gives rise to a deduction without inclusion 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;

[93] EC Tax review 2017-3, supra 78, p. 159.
[94] IBFD, Thomas Balco, *ATAD 2: Anti-Tax Avoidance Directive*, p. 128.
[95] EC (2016) ATAD 2, *Supra 89.*
[96]Article 9a of ATAD 2.
[97] *WFR 2017/113,* Report Tax Conference ATAD 1 and ATAD 2, 26 May 2017, P. 719. The so-called single tax principle.

(e) a payment by a hybrid entity gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction;

(g) a double deduction outcome occurs.

In this way, the reverse hybrid entity mismatches are dealt with in different ways in ATAD 2. Similar to BEPS Action 2 and ATAD 1, it deals with the symptoms and not the cause of hybrid mismatches. In addition, to be more in line with the OECD Recommendations, ATAD 2 is extended with the secondary rule in paragraph 1 and 2 of Article 9. Both the primary and secondary rules are neutralizing mismatches resulting in a DD and D/NI outcomes. It also applies in relation with non-EU States.

3.3.2 Reverse Hybrid Entity Mismatches

In respect with reverse hybrid mismatches[98], Article 1 of ATAD 1 is extended with paragraph (2) in ATAD 2*: "Article 9a shall also apply to all entities that are treated as transparent for tax purposes by a Member State"*. This new provision was essential to cover transparent entities which are not liable to CIT within the EU. The new inserted Article 9a covering reverse hybrid mismatches reads as follows:

1. Where one or more associated non-resident entities holding in aggregate a direct or indirect interest in 50 percent or more of the voting rights, capital interests or rights to a share of profit in a hybrid entity that is incorporated or established in a Member State are located in a jurisdiction or jurisdictions that regard the hybrid entity as a taxable person, the 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.

2. Paragraph 1 shall not apply to a collective investment vehicle. For the purposes of this Article, 'collective investment vehicle' means an investment fund or vehicle that is widely held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established.

This new provision, however, only applies to reverse hybrid entities *situated within the EU*. In order to ensure that reverse hybrid entities situated in third countries are within the scope of ATAD, the definition "Hybrid entity" is added to article 2(9) in ATAD 2 and article 9(2) (D/NI) is equally adjusted. Article 2(9)(i) of ATAD 2 defines hybrid entities as *"any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure of one or more other persons under the laws of another jurisdiction"*. Correspondingly the aforementioned, the adjusted article 9(2) (D/NI) is used for payments to reverse hybrid entities established or incorporated *outside the EU*[99]. As chapter 4 of Action 2 recommends, Article 9(2) provides that:

(a) the deduction shall be denied in the Member State that is the payer jurisdiction; and

(b) where the deduction is not denied in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome shall be included in income in the Member State that is the payee jurisdiction.

[98] EC Tax review 2017-3, supra 78, p. 157.
[99] EC Tax review 2017-3, supra 78, p. 157.

In this manner, both hybrid and reverse hybrid arrangements are covered and includes non-EU situations. So, the scope of ATAD is effectively broadened from reverse hybrid entities within the EU to such entities established outside the EU.

The rule on reverse hybrid entity mismatches assures that Dutch CV's in a CV/BV structure are not used as reverse hybrid entities by US MNEs. It prevents that payments to the CV are deducted while not taxed as income at the level of the CV, and at the same time not taxed at the level of the US partners. In fact, taxation in the US are deferred since payments are not distributed to the partners resident in the US *(before the US tax regime of 2018).*

Finally, the opting-out rule in article 9(4) gives the MS the choice to exclude certain mismatches with a D/NI outcome[100]. So, the Netherlands is allowed not to include the payment in the income of the reverse hybrid entity (CV), whilst deducted in a third state (US). The reason for such a rule is unclear. Probably, this does not concern article 9a of ATAD since Preamble 29 states that arrangements subject to this article other ATAD provisions are out of scope. The optional defensive rule may be a political choice, as the rule is more relevant involving non-EU States[101].

3.4 Measures against Hybrid Entity Mismatches

Since, the rules on reverse hybrid entities are already discussed the application of Articles 9(2) and 9a of ATAD 2 are shortly explained in this section. The hybrid entity with disregarded payments (D/NI) is discussed (*section 3.4.1)* as well as disregarded payments to a reverse hybrid entity established or incorporated in the EU (section *3.4.2*) or third countries (section *3.4.3*).

3.4.1 Hybrid Entity with disregarded payments (D/NI outcome)

A, B, and C are associated enterprises. The State of establishment, State II, considers the hybrid entity B as non-transparent and State I as transparent. State I, therefore, does not recognize the transactions between both states and does not include the royalty in the income of A Co. State II, on the other hand, recognizes the payment and is deducted by hybrid entity B. The royalty payment by B Co is set-off against C Co's income under a group tax regime in State II. This structure is a HMA with a D/NI outcome according to Article 2 paragraph 9(e) of ATAD 2.

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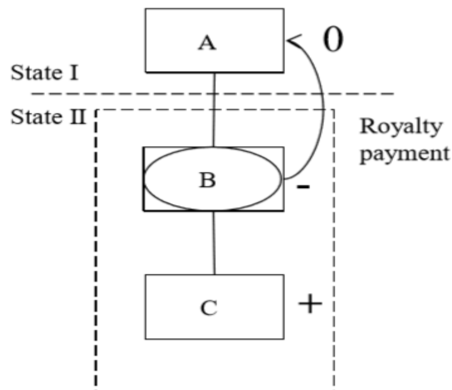
[100] *Ibid,* According to art. 9 par. 4, MS are allowed to exclude in art 9 par. 2 the following situations: (1) the scope of *art. 9 par. 2 (a) and (b)* as regards *hybrid financial instruments* issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements, not for avoiding tax (see also preamble 17). This rule applies till 31 December 2022. The payer state may permit the tax payer to deduct the (interest) payment, even if it is not included in the payee state. Also, the payee state is not required to include in the income. (2) the scope of *art. 9 par. 2 (b)* as regards hybrid mismatches in art. 2 (9) par.1 (b) payment to a (reverse) hybrid entity, (c) payment to an entity with one or more PEs, (d) payment to a disregarded PE and (f) a deemed payment between head office and a PE or between PEs. The payee state even here could exclude the deducted payment from the income.

[101] Rijksoverheid.nl, redactionele aantekeningen, Antibelastingontwijkingsrichtlijn 2 (ATAD 2) V-N 2017/36.3, 11-07-2017. But also the aim of this opting-out rule may be to preserve the obligations with third states. In such context, treaty override could occur where the treaty provides an exemption and the Directive (enforced) inclusion of the income in the payee MS and tax it accordingly. In case of a reverse hybrid entity, this entity does not fall under the scope of the OECD MC and no treaty override will arise. See *Supra 127*.



The ATAD 2, as the BEPS Action 2, provides a primary rule which entails denying the deduction in the MS of the payer jurisdiction, State II[102]. If the deduction is not denied in State II, the secondary rule will be applied implying that the amount of the royalty will be included in the income of the MS, i.e. entity A Co[103]. This may be the case where State II is a third state. The secondary rule was lacking in ATAD 1.

A mismatch will arise if the deduction exceeds dual inclusion income. This is extensively explained in BEPS Action 2. ATAD 2, however, provides the definition of "*dual-inclusion income"* [104]. Similarly, at point 129 of the BEPS report follows that carry-back and carry-forward could also be considered, whereas the ATAD 2 deviates from it and is limited to carry-forward without further clarified[105].

Article 2 paragraph 9 of ATAD 2 defines the *payee jurisdiction* as in the *D/NI definition* i.e. any jurisdiction where that payment or deemed payment is received, or is treated as being received under the laws of any other jurisdiction. In the above situation, from State I tax point of view the payment is not recognized. Given that article 9(1) of ATAD 2 is applicable, *received* should be understood from State's I civil law perspective, rather than from its tax law. State II considers the payment as received by A Co in (Member) State I[106].

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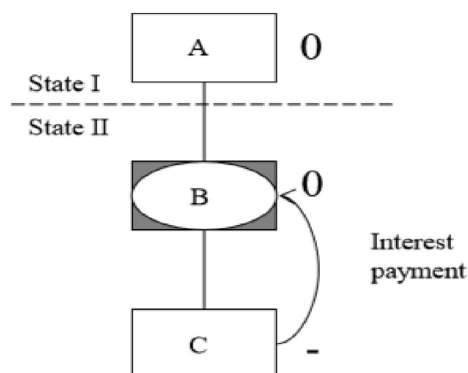
[102]Article 9 (2)(a) ATAD 2.
[103]Article 9 (2)(b) ATAD 2.
[104]Article 2 (9)(g) ATAD 2.
[105] Rijksoverheid.nl, *Supra 115*, p. 13/24. If the hybrid entity has a positive income, double taxation may arise. Preamble 5 ATAD 1 includes other obstacles such as double taxation should receive tax relief. This is solved in ATAD 2 in which the inclusion is limited to the amount of payment that would otherwise give rise to a mismatch. Also, Preamble 20 of ATAD 2 states that if the payer jurisdiction allows the deduction to be carry-forward in subsequent period, the secondary rule under ATAD 2 could be deferred until the deduction is actually set-off against non-dual inclusion income. This is in case of *a payment by a hybrid entity to its owner* with a D/NI outcome.
[106] EC Tax review 2017-3, supra 78, p. 163.

3.4.2 Reverse Hybrid Entity in EU (D/NI outcome)

This structure resembles the previous examples of hybrid entity with disregarded payment (D/NI) and payments made by a hybrid entity (DD), except without a group tax regime. In this scenario, State I considers the hybrid entity B as non-transparent and in State II treated as transparent. Accordingly, for tax purposes a payment to B, established in State II, will not be taxed. The interest payment from C Co to B is deducted from C's perspective, whereas State II perceives the payment to be received by A Co in State I. At the same time, State I allocates the payment to B in State II. Neither states will tax the income, while the interest is deducted at the level of C. This HMA structure with D/NI outcome falls under Article 2, paragraph 9(b) of ATAD 2.

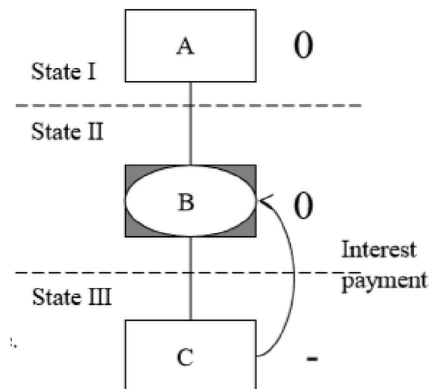


As discussed before in this chapter, ATAD 2 extended the objective scope of ATAD 1 with inter alia two provisions regarding reverse hybrid entities. I.e. the regular anti-hybrid measure against HMA with a D/NI outcome in Article 9(2) and the lex specialis Article 9a[107]. The latter provision takes precedence over Article 9(2) according to Preamble 29. The lex specialis provision covers reverse hybrid entity established or incorporated in a MS. This special article states that …'*the 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.'* This could be understood, from my view, that the MS of the transparent entity B, state II, should treat the entity as fiscally non-transparent and tax the received interest payment accordingly. This is comparable with Recommendation 5.2 of BEPS Action 2 which suggests to turn off the transparency of the reverse hybrid entity and treat it as a resident taxpayer.

By contrast, Preamble 30 of ATAD 2 shows that if other provisions, such as the Parent-Subsidiary Directive[108], would neutralize the hybrid mismatch outcome, the rules provided in ATAD 2 are no more applicable. This goes for both Articles 9(2) and 9a of ATAD 2 in situations between MSs.

[107] Preamble par. 29 of ATAD 2: '*The hybrid mismatch rules in Article 9(1) and 9(2) only apply to the extent that the situation involving a taxpayer gives rise to a mismatch outcome. No mismatch outcome should arise when an arrangement is subject to adjustment under Article 9(5) or 9a and, accordingly, arrangements that are subject to adjustment under those parts of this Directive should not be subject to any further adjustment under the hybrid mismatch rules.'*
[108] Council Directive 2011/96/EU of 30 November 2011 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, OJ L 345/8 (2011).

3.4.3 Reverse Hybrid Entity in third country (D/NI outcome)



In this situation, the reverse hybrid entity is situated in a third country, State II. Now, article 9a is not applicable and, instead, the regular article 9(2) of ATAD applies. Both the MSs I and III classify this entity B as non-transparent. Accordingly, C Co deducts the interest payment to entity B (State II) against its results from State III point of view. In State I, the interest is not included in the income of A Co but allocated to the reverse hybrid entity. With the effect that the payment is not taxed at all since the third country treats entity B as fiscally transparent.

According to article 9(2) of ATAD, the payer state, State III, should deny the deduction in case of a D/NI mismatch[109]. If not, State I should apply the secondary rule[110]. This would be different if State III is also a third state. Than none of the rules of ATAD applies

In this context, the opting out provision[111] leaves the choice to the MS *not* to implement the secondary rule in its national tax law. This latter rule is also lacking in chapter 4 of the OECD Report. In my opinion, it is for the sake of the MS (State I) to implement this rule. This way, A Co holding an interest in B shall include his share in its taxable base in State I[112]. As a result, that aggressive tax planning of such structures would be less attractive for taxpayers. Mostly, inserting a reverse hybrid has the sole purpose of reducing the (withholding) tax, as they have no real economic activity in State II.

[109]Article 9 (2)(a) ATAD 2.
[110]Article 9 (2)(b) ATAD 2.
[111]Article 9 (4)(a) ATAD 2.
[112]Article 62(1) CCTB recommends to allocate the income of transparent entities to tax payers holding an interest, *where an entity is treated as transparent in the Member State where it is established, a taxpayer holding an interest in the entity shall include its share in the income of the entity in its tax base. For the purpose of this calculation, the income shall be computed in accordance with the rules of this Directive*. Despite the fact this only applies among Member States, this would also be a good solution to tackle aggressive tax planning involving third countries.

3.5 Interim conclusion

The ATAD provides measures to effectively combat aggressive tax planning structures making use of disparities between domestic tax systems. Its purpose is to guarantee the single tax principle in cross-border transactions by removing the disparities resulting in gaps. By taxing at least once and *not* where value is created based on substance, it seems to me that economic reality is neglected under ATAD. So, the origin principle (taxation at source) is again disregarded similar to the approach in BEPS Action 2.

ATAD 1 was a good starting point to ensure, through hard law, that MSs will implement the rules being effective. However, ATAD 1 was not extensive enough. It did not cover transparent entities. So, an article for reverse hybrid entities and a new definition in Article 2(9) were added in ATAD 2. It is remarkable that it can be found directly in the articles or via a detour in the Preamble ending up in Article 9(2). Especially, in case of contradictions the Directive itself supersede the preamble which could lead to uncertainties. Also, the definitions were not clearly specified resulting in other interpretation issues. For this reason, new definitions were added in ATAD 2 and other terms were clarified to broaden it context.

Further, the secondary rules are crucial and added which was lacking in ATAD 1. Its background, probably, was if all MSs implement the primary rule would suffice. Similar to Action 2, in which circumstances the secondary rule of ATAD 2 should be applied is in some cases vague. There are some doubts whether the amended ATAD is more effective than ATAD 1. E.g. the opt-out provision states that MSs *not necessarily* need to apply the secondary rule for some structures with a D/NI outcome. Since this might result in arbitrage opportunities, I find it more interesting whether all MSs are consistently implementing those rules to close the remaining loopholes. Its background is not very clear and not all MSs may use this opportunity. In this context, the minimum standards of ATAD will not help to implement the rules in a common and coordinated manner. The MSs are even offered to apply the rules more strictly in their national law. This could still result in some gaps leading to inconsistencies between jurisdictions. In addition, not all the OECD approaches of Action 2 are in line with Union law. The MSs are facing an uneasy challenge when transposing ATAD in their domestic law. It is unclear which OECD approach they should take. More issues arise accordingly in the internal market.

Finally, ATAD 1 was limited to measures between EU MSs. This way, e.g. US investors in the EU would have had a competitive advantage compared to EU-investors. I believe, this was not intended since the EU wants to improve fair taxation among states. For this reason, ATAD 2 expanded the scope to structures in relation with third countries. Also, it is restricted to corporate structures and *only* symptoms with DD and D/NI outcomes. Other situations were neglected.

All in all, it is regretful that the cause of mismatch arrangements, i.e. the classification differences, are not addressed to eliminate the disparities completely within the internal market. This way outcomes resulting both in double non-taxation and double taxation will be contested, even structures where individuals are involved. It is worth considering, based on multilateral collaboration between states, that MSs apply comparable features of foreign and domestic entities. So, a similar distinction would be made between transparent and non-transparent entities. Hereby, the key is to identify value creation at source. This is doubtful in respect with the proposed solution of reverse hybrid entities as no real economic substance might be present in the state where it arises. So, the latter is not my best option, and more action is needed to close the gaps among states.

Chapter 4 The position of the Netherlands

After outlining the anti-hybrid measures from the OECD and the European perspective, the focus of this chapter is on the effectiveness of ATAD, in particular ATAD 2, regarding reverse hybrid entities in the Netherlands in relation with the United States, further US. How the Netherlands implement those anti-avoidance rules and whether it has the desirable effect as expected is analysed below.

4.1 The implementation of the Anti-Tax Avoidance Directive 2 (ATAD 2)

The Netherlands will implement the ATAD 2 with statutory rules preventing the use of hybrid structures before 1 January 2020. In respect of this, a draft bill will be expected at the latest June 2019[113]. For this reason, the Ministry of Finance published a consultation document concerning this Directive on 29 October 2018 where other interested parties responded to this draft bill. On the other hand, the "*subject-to-tax measure"* for *reversed* hybrid entities will be transposed before 1 January 2022 and are adopted in this document as well[114]. According to the approved motion-Merkies[115], the latter date may not be foreseeable since this derogation is complex for the law as well as for the execution. We have to see how this works out. In this chapter, the bill and the changes it concerns for CIT are discussed.

4.2 The objective of the Government (Cabinet)

In recent years, the so-called CV/BV-structure evolved into the symbol of hybrid mismatches. Such structures are allowing, particularly, US MNEs to defer taxation over their worldwide income excessively. Similar to the US goal, the Netherlands want to remove the tax incentive of a CV/BV-structure by implementing the entire ATAD 2. The Cabinet, however, is considering not to exclude *financial traders and certain financial instruments* from its scope[116]. This way, according to the Cabinet, tax advantages of HMA's are more mitigated and, hence, tax avoidance will be tackled[117].

How effective the ATAD 2 will be depends on the discretion of the Netherlands and their different choices to implement the rules. The Netherlands does not take into account to what extend the ATAD is implemented in the other MS. It appears that the Government initially wanted to change their image of a tax haven instead of eliminating HMA's[118]. In addition, it neglects the *US Tax Reform* in 2018 in which President Trump neutralises the mismatches from the US perspective. Interesting is how this will interact with ATAD 2 rules[119]. Possibly, after ATAD 2 is implemented into the Dutch CIT which is becoming more complex, international arrangements will have to be re-evaluated and, if any, adjusted.

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[113]. Stakeholders could give their opinions or reactions on this document prior to the presented bill in June 2019.
[114] https://www.ndfr.nl/Nieuws/Item/2314 and link to the Consultation document (*further Consultation*), section 1.
[115] Motion-Merkies (V-N 2017/12.10). The Minister Dijsselbloem of Finance already expressed that he did not want to use the implementation date of 1 January 2022. However, this is not yet clear and in the other sections of this thesis the author applies the latter date.
[116] Consultation, *Supra 114*, section 2. The interest payments under certain financial instruments (D/NI) to an associated enterprise will not be excluded from the scope of the transposed ATAD 2. See Article 9(4)(b) and 9(2)(a) and (b) of ATAD 2.
[117] Consultation, *Supra 114*, section 2.
[118] The Second Chamber, conference year 2017-2018, appendix; conference year 2018-2019, 25087-230, International tax policy of *28 March 2019*. The NL is not on the list of non-cooperative jurisdictions based on the criteria of the EU code of conduct group: (1) implementation of the BEPS minimum standards. It even goes further than other OESD states, (2) tax transparency, where the NL exchanges information to other states, and (3) no harmful competition. See also *Supra 157*, section 2..
[119] Wolters Kluwer V-N 2017/36.3, Anti-Tax Avoidance Directive 2 (ATAD 2), 11 July 2017, p. 22.

4.3 Implementation in the Netherlands, some observations

The measures of ATAD 2 shall apply if a hybrid mismatch arises between *associated enterprises* and in case of a *structured arrangement*. The Netherlands has opted to implement the term of *associated enterprises*[120] in line with ATAD 1 implying that there should be at least 25% direct or indirect equity participation. The definition for structured arrangements, on the other hand, is equal to ATAD 2[121].

Similar to ATAD 2, the draft bill aims at neutralizing the HMA outcomes with the primary rule and, if not, the secondary rule applies. The Netherlands expects that solely the primary rule shall be used in intra-EU situations with the condition that other MSs have implemented those measures too. The secondary rule shall, accordingly, be used in relation with third states[122].

Although each EU MS has its own tax qualification of instruments and entities, the tax law of the MS concerned determines the existence of a hybrid mismatch. The undesirable outcomes resulting from different definitions among MSs shall be neutralized and, by exception, the "*subject-to-tax measure"* for reversed hybrids and PE's are tackled from its cause.

In case other measures from Dutch CIT and the anti-hybrid rules apply simultaneously to reduce base erosion, the interest payment should be deducted once. If the interest is partly restricted, both measures could complement each other. Further, a specific rule supersedes a general rule. This implies that if a hybrid mismatch rule applies, after that, the earningstrippingrule of ATAD1 cease to have effect[123].

4.4 Reverse Hybrid Entity Mismatches

The CV/BV structures are used by US MNEs to benefit from the tax advantages that arise accordingly. The CV – a reversed hybrid entity- is disregarded in the state of incorporation or establishment, while treated as non-transparent in the country of the participants, the US. The income of the transparent entity is not included at the level of the CV, and the state of the US Participants allocates the income to the CV with the help of the check-the-box system in the US. This results in a D/NI outcome due to this qualification differences between those states albeit that technically the income will be taxed in the US once it is distributed to the US. In order to understand such structures, the purpose and the treatment of the CV/BV structure from Dutch perspective will be examined in this section.

4.4.1 The Dutch CV/BV structure

A *commanditaire venootschap* (CV) is a limited partnership which makes a distinction between two types of partners. The *general partners* are involved in the operation and the control of the partnership, and they are jointly liable for all the obligations of this partnership. Secondly, the *limited partners* are financing the partnership and share the profit accordingly. They are excluded from the external management and the responsibility is limited to the amount of their investment in the partnership[124]. Dutch law differentiates between a closed and an open CV. A closed CV is transparent for tax purposes and, hence, is not a taxable entity. The closed CV can also be used as a tax shelter with the purpose to defer taxation – an artificial arrangement. Under this partnership, none of the partners can be replaced unless it is *unanimously* decided by all partners.

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[120] Dutch Article 12aa(2)(a) and Article 12ac(2) CIT 1969 (definition).

[121] Consultation, *Supra 114*, section 3. Dutch Article 12aa(2)(d) in relation with Article 12ac(1)(f) CIT 1969 (definition).

[122] Consultation, *Supra 114*, section 3.

[123] Consultation, *Supra 114*, section 3.

[124] https://www.internetconsultatie.nl/moderniseringpersonenvennootschap, the Bill of *modernization of partnerships* will adjust the legislation of the CV. Until 31 May 2019, a reaction can be given to the consultation document which is published on 21 February 2019, Articles 820 -822 of this document, and either the provisions of the general partnership applies in this respect.

Further, a *besloten vennootschap* (BV) is a limited liability company, a legal entity, with shareholders who established the BV. The day-to-day management is in the hands of the board which in the setting up is chosen. The shareholders are (limited) liable to the amount of their initial capital in the BV, unless the (large) shareholder signs privately or due to mismanagement[125].

In practice, a *CV/BV structure* is created for liability and tax purposes by many US MNEs. The purpose is to prevent being taxed for their profits outside the US. A 'closed' CV is formed by US partners, usually US entities such as a LLC. The *general partner of the CV* has a small participation in the CV – less-than-5%- and is resident in the US or in a tax haven. The other partner, a US-resident company, is the *limited partner* who have a larger part of the CV (more-than-95%). The CV is 100% shareholder of the BV, which in turn, holds the shares of the (several) non-US subsidiaries of the MNE. The CV may operate as an intangible property (IP) holding company. In addition, the CV may enter into loan contracts with the BV and/or other group companies to lend the excess cash once again to the group companies. This structure is an advantageous opportunity for US MNEs by channelling the profits of the subsidiaries into the CV as interest or royalty payments or dividends distributions.

4.4.2 The Dutch treatment of a transparent entity – CV/BV structures

According to the Corporate Income Tax Act (*Wet op de Vennootschapsbelasting 1969*), further CIT, an entity is regarded as a domestic taxpayer - taxed on its worldwide income – if it is explicitly listed in Article 2 of CIT. Hence, a domestic taxpayer is treated as a non-transparent entity. A Closed CV, however, is excluded from this provision and therefore not liable to tax. This entity is transparent for the CIT established under Dutch civil law[126].

Irrespective that no taxation takes place at the level of the CV, the *US limited partners in the CV* may be taxed from Dutch view since they are designated as the recipients of its share of the earnings from the CV. The *15% Dutch withholding tax* (WHT) may be imposed on dividends payed by the BV, and *subject for CIT on royalties* paid by the BV to the CV. The latter is deemed to be dependent on the profits of the enterprise carried on by the BV[127].

In case of royalty payments, *"the profit rights provision"* applies and, hence, CIT may be taxed in case the following conditions are met[128].

1) The royalties can be considered income from rights to the profit of an enterprise;
2) That enterprise is managed from the Netherlands; and
3) The royalties do not originate from securities.

In respect of term 1, the wording of this provision implies that, aside from the US partner, an enterprise could be carried on by a BV. The US taxpayer must be directly entitled to its part of the profit of the enterprise carried on by the BV. In case the US partner grants a loan or licenses intangible property (IP) to the BV, the interest income or the royalty payment are subject to CIT as long as the remuneration is

[125] A Dutch book: *The core of Company Law* (De kern van het ondernemingsrecht), Kroeze, Timmerman and Wezeman, Kluwer third edition, p.4-6.
[126] Article 2(1)(a) CIT. An open CV is, however, a domestic taxpayer regarded as a resident entity in the Netherlands and taxed on its worldwide income. Article 3 CIT covers foreign taxpayers, not incorporated in the Netherlands, where solely the income that has a nexus with the Dutch territory is being taxed.
[127] Jan Vleggeert, *European Union/Netherlands - Dutch CV-BV Structures: Starbucks-Style Tax Planning and State Aid Rules*, Bulletin for International Taxation, 2016 (Volume 70), section 3.1 (hereinafter Vleggeert).
[128] Article 17a(b) CIT.

dependent on the profits of the Dutch enterprise[129]. This provision, however, does not apply to royalties depending on the *turnover* of the enterprise but on the *profit*. This is determined in Dutch case law based on the difference between the *actual pre-tax profit of the BV (and before royalty payments to the CV)* and *the profit following the BV's Advanced Price Agreement (APA) as agreed upon with the Dutch tax authorities*. This means that the royalties are calculated as a residual profit.

As to the second term, following that the enterprise need to be managed from the Netherlands, this provision requires that the *enterprise itself* need to be managed from the Netherlands, *not the BV*. In this situation, the enterprise of the BV assumed to be managed from the Netherlands. Hence, this condition is also met.

Finally, the fact that royalties do not originate from securities could be affirmed since IP is not a security. The term " securities" are, in general, tradable shares and bonds. The rationale for this last term is to exclude foreign shareholders in Dutch entities from the scope of this provision.

All in all, based on the three conditions of the profit rights provision, the US partner is subject to Dutch CIT on royalties and interest paid by the BV to the CV[130].

4.5 The Netherlands – United States Income Tax Treaty (1992)

In this section the treatment of the hybrid entity from Dutch treaty policy is discussed, including the hybrid entity provision (*4.4.1*). second and last, the application of the Netherlands – United States Income Tax Treaty, further Dutch-US tax treaty, is elaborated (sections *4.4.2* and *4.4.3*).

4.5.1 The treatment of Hybrid entity

The OECD "Partnership Report" [131] analysed the treatment of partnerships from which the conclusions are added into the commentaries on Article 1 of the OECD MC[132]. The OECD Report covers the entitlement to treaty benefits of partners if the partnership is non-resident[133]. In such cases, the source state should take into account how the item of income arises in its jurisdiction is dealt with in the taxpayer's jurisdiction of residence. Accordingly, the source state is obliged to decrease its domestic tax claim where that income is liable to tax in the other contracting resident state[134].

In respect of those *principles* regarding CV/BC structures [135], the Report concludes that the Netherlands as *source state is not obliged to broaden the Dutch-US tax treaty benefits* to the income that the US resident state assigns to the CV. Since the conclusions of the Report are not very clear, Article 1 of the OECD MC was extended with a second paragraph to incorporate the principles of this report[136]. However, the Netherlands made some reservations as they questioned whether there was a legal basis for such solution. In addition, it argued that fundamental amendments to the OECD Commentaries, after a bilateral tax

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[129] See the Hague Court of Appeals (Hof Den Haag 6-3-1961), No. 26/1961, BNB 1961/324. The Court ruled the same. But in this case the taxpayer was a *resident of the UK* who granted a loan to the BV against 5% interest remuneration per year. The interest was a crucial part of the profit of the Dutch enterprise and this interest income was taxed accordingly with Dutch CIT.

[130]. Vleggeert, *Supra 127*, section 3.2

[131] This Report is called: *The Application of the OECD Model Tax Convention to Partnerships* (1999), further Partnership Report.

[132] *OECD Model Tax Convention on Income and Capital* (2017), Commentary on Article 1 par.2.

[133] Chapter II.4 of the *Partnership Report* (1999).

[134] Vleggeert, see *Supra 127*, par. 3.3.2., also see OECD (2015), par 51 and 53, and the commentary par. 5 of Article 1 par 2 of OECD MC 2017.

[135] See for example 3 of the *Partnership Report* (1999).

[136] OECD (2015), par. 435.

treaty is concluded, do not automatically apply to existing tax treaties. Unless, this is explicitly (mutual) agreed between the competent tax authorities or unilaterally.

Nevertheless, a hybrid entity provision was incorporated in the Dutch-US Tax Treaty in 2005. From this provision, Article 24(4), follows that the Netherlands only grants treaty benefits, i.e. reducing the dividend withholding tax if the income is taxed in the US. In other words, this non-discrimination provision is not applicable for CV/BV structures. The income derived through a tax transparent entity is in neither contracting states treated as the income of one of its resident. Hence, the income is not taxed in the hands of the US partners and no treaty benefits are granted. The hybrid entity provision is, therefore, consistent with the Partnership Report. The Netherlands should interpret the treaty according to Dutch tax law. So, if the CV is tax transparent for Dutch CIT, it is either transparent for treaty purposes[137].

Initially, the Dutch State Secretary for Finance in the Decree of 2005[138] agreed that Netherlands do not have to reduce its tax on dividends or royalties. He argued that from the purpose of the hybrid entity provision, qualification differences of an entity (CV) should not result in double taxation or non-taxation. Nevertheless, he noted that this was disadvantageous for US companies holding shares in a BV through a transparent entity, thus, an exception was made for such structures. In this regard, (1) the CV must take part in a BV performing substantial activities via or in the Netherlands; (2) the BV undertakes "real" economic activities (produce or distribute goods); and (3) the investment provides sustainable jobs[139].

If these conditions are met, Article 24(4) of the Dutch-US Tax Treaty regarding hybrid entities is non-applicable. Instead, the participants with a tax residence in the US are able to invoke the benefits of this treaty ***until 2020***. ***As from 2020***, the aforementioned policy statement[140] under the Dutch-US income tax treaty will be *repealed* where the reduced rate for dividends applies regarding such entities[141].

4.5.2 Dividends distributed by the BV to a CV

The US partner is subject to 15% WHT on dividends paid by the BV under the Dutch Dividend Tax Act 1965[142]. The dividends are received through a CV which is transparent under Dutch tax law. It follows from the hybrid entity provision, that the dividends are considered to be derived by the US partner in the CV as long as it is treated as income of the partner under the US tax law. On the other hand, the US check-the-box system allows US taxpayers to reclassify the transparent entity into an opaque entity. The dividends are regarded as income of the CV and, hence, fall not under the scope of Article 10 (dividends) of the Dutch-US Tax Treaty. Consequently, the US partner is not entitled to the reduced WHT of 5% under Article 10(2) of the tax treaty, nor to an exemption under Article 10(3). Still, by virtue of the Decree of 6 July 2005, if the requirements are met by the US partner, he will be only subject to 5% Dutch WHT or, instead, exempt entirely[143].

4.5.3 Royalties paid by the BV to the CV

Under Dutch law, the US partner is subject to 25% CIT on royalties. This rate is not reduced due to the hybrid entity provision of the Dutch-US Tax Treaty. So, the royalties are not deemed to be derived by the

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[137] Dutch "Kamerstukken II 2003/04, 29632, n. 3, pag. 14,15,29 and 31.
[138] Dutch Decree of 6 July 2005, nr. IFZ2005/546M. This Decree initially applied to the Dutch-US Tax treaty but is now outdated since the Netherlands included similar hybrid entity in other tax treaties since 2006.
[139] These conditions apply to BV's that do not only function as holding, intra-group financing or intra-group licensing companies, but also producing or distributing goods. See also Vleggeert, *Supra 154*, par. 3.3.3.
[140] Policy Statement of 6 July 2005, *Supra 164*.
[141] https://meijburg.com/news/public-consultation-on-bill-implementing-atad2.
[142] NL: Wet op de Dividendbelasting 1965 (Dutch Dividend Withholding Tax Act 1965).
[143] Vleggeert, see *Supra 127*, par. 3.3.4.1.

US partner in accordance with Article 13 of the treaty. However, if the BV performs substantial activities via or in the Netherlands pursuant to the Decree of 6 July 2005, this Decree also applies to royalties. This constitutes that Article 13 (royalties) applies instead of the hybrid entity provision[144].

Based on Article 13(1) of the Dutch-US Tax Treaty, royalties arising in one of the states and beneficially owned by a resident of the other state are taxed in the other state. Consequently, if royalties distributed by the BV to the CV under Article 13(2) of the treaty, the US partner is tax exempt for the Dutch CIT. However, Article 13(6) includes an exemption if three terms are met, if not, the Netherlands may levy 15% tax on the gross amount of the royalties. The conditions involves (1) that royalties must be attributable to a PE of the US partner; (2) the profits of the PE must be less than 60% of the general rate of the US CIT, including taxes imposed in the other state; and (3) the royalties may not be a remuneration for the use or the right to use intangibles produced or developed by the PE. The PE definition of Article 5(2) of the Dutch-US Tax treaty includes, in particular, a place of management. In this case, if the CV is managed from the Netherlands, it may entails a PE of the US partner in the Netherlands from Dutch point of view. Hence, based on Article 13(6) Dutch-US Tax treaty, the Netherlands may levy 15% CIT on royalties with the condition that the tax rate of the Netherlands (third state) does not exceed 21%[145].

4.6 The CV/BV structure as Reverse Hybrid Entity

4.6.1 CV/BV Structures: pre-ATAD and pre-US Tax Reform

Many US parent companies use the CV/BV structure to make advantage of classification differences among states. They form a closed CV which owns a BV in the Netherlands. A *substantial* part of the profit of the BV is transferred through the CV to the partners in proportion of their share. Accordingly, the partners compensate their income at will by the large amount of profit since the CV is transparent in the Netherlands. However, they could either avoid tax liability on their profits from abroad because the CV is non-transparent in the US with the help of the “check-the-box system” [146]. With this system the US partners could easily elect whether they characterize the concerned entity as transparent or non-transparent for tax purposes, applied both to domestic and foreign companies[147]. So, the opposite treatment of the CV is chosen. This way, the income is disregarded in the CV and the non-resident partners did not receive their income in the US. In fact, the profit remains in the Dutch CV. As a result, both states are neither taxing the income. Besides, the US taxes the worldwide income of US residents based on the *nationality principle*. Hence, the US has a tax claim on the profits received from the Netherlands or other states. The *actual taxation* takes place if the profits are *repatriated* to the US against *35% CIT*. The US tax system applies a credit system for taxes paid outside the US. This system allows to defer taxation in the US, yet once the income is received in the US tax will be levied[148]. However, this all changed due to the US Tax Reform and the ATAD, explained hereafter.

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[144] Vleggeert, see *Supra 127*, par. 3.3.4.2., and also *supra 167*, Dutch Decree of 6 July 2005.
[145] Vleggeert, see *Supra 127*, par. 3.3.4.2.
[146] Vleggeert, see *Supra 127*, par. 3.3.4.2.
[147] This elective approach has two alternatives. Option 1: entity is classified as a corporation and is non-transparent. Option 2: partnerships and disregarded entities are transparent for tax purposes. The difference between those two is that a disregarded entity has one participant, and a partnership has two or more partners. See Regs.sec 301.7701-3 of the Code of Federal Regulations.
[148] https://docs.house.gov/billsthisweek/20171218/Joint%20Explanatory%20Statement.pdf. Pag. 466-471.

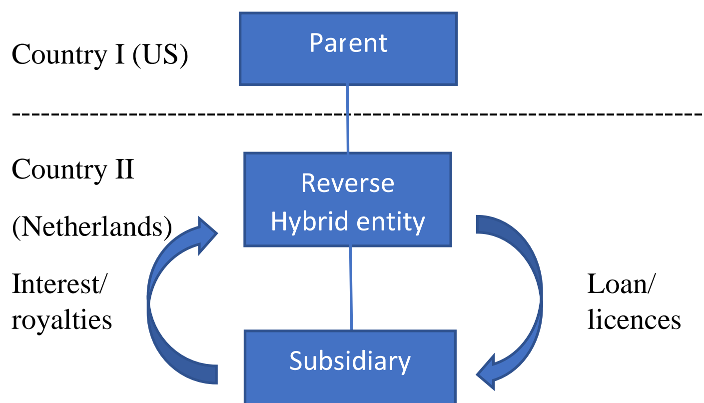
4.6.2 The ATAD 2 scenario for the CV/BV structure

The CV/BV structure is a great opportunity for US parent companies by distributing the dividends, royalty or interest payments of their BV through a CV with the effect of tax deferral in the US and non-taxation in the Netherlands due to transparency issues[149]. This structure could be outlined as follows.

The parent company grants excess cash (equity) to the CV which, on its turn, provides a loan to the BV. This allows the BV to refinance activities globally conducted by the subsidiaries of the US MNE. The BV, a "passthrough entity", pays the CV interest which is deductible for the BV in the Netherlands. The interest the CV received from the BV is not taxed since the interest income is allocated to the US partners from Dutch view. The US is taxing the interest if the income (profits) is being transferred to the US. If the profit is not repatriated, no taxation takes place but results in a deferral. Similarly, instead of granting excess cash, the parent may license or transfer IP to the CV. The BV receives the royalty payments from MNE's subsidiaries in other states for using the IP. The BV, in turn, pays the royalties to the CV and , hence, the BV deducts the payments. Accordingly, the profit is again not taxed at the level of the CV in the Netherlands *(before the US Tax Regime in 2018).*

In this respect, this structure is recognized as a *reverse hybrid entity* under Article 2(9)(b) of ATAD since the outcome is D/NI. The interest is deducted in the Netherlands by the BV and not included at the level of the CV. The CV is classified as fiscally transparent in the established jurisdiction, state II, and opaque in the jurisdiction of the US MNE (state I). Both the BEPS Action 2 rules as the ATAD provisions wants to ensure that such structures are avoided.

The next figure shows a reverse hybrid entity which is mostly financed with equity and grants loans or licenses IP to the BV (subsidiary). This reversed entity is regarded as non-transparent from state I perspective and allocates the interest income to state II. This results in non-taxation of the income because state II classifies this entity as transparent.



In this case, state II is a EU MS, Article 9(2)(a) of ATAD applies where the payer jurisdiction (state II) must deny the interest deduction. As from 2022, this will change. The Netherlands will introduce the provision *subject-to-tax measure* of Article 9a ATAD in Dutch tax law. The reverse hybrid entity, the CV, is treated as opaque for tax purposes in state II, instead of tax transparent. So, the entity becomes liable to Dutch CIT for its worldwide income. Hence, the interest income of the CV is taxed in state II as

[149] *Supra 127,* Vleggeert, p. 173-174. The US subsidiaries could be a resident in a tax haven, e.g. Bermuda, and the CV holds all the shares in the Dutch BV. The CV is mostly used as a tax shelter.

long as it is not taxed in other states. In this case state I. The same applies for royalties and dividends. In this context, Article 9(2)(a) will not be applicable[150] due to the lex-specialis article 9a of ATAD. Consequently, the payments are still deductible for the BV because the corresponding income is taxed at the level of the CV[151].

Article 9a deals with the cause of hybrid mismatches which implies that the Netherlands treat the hybrid as a standalone entity[152]. Its tax treatment depends wholly on the treatment of this entity in the other (US) state, in this case, in the hands of the participants. This way, even double taxation is prevented. Further, the CV is deemed to conduct his business with all his assets to ensure that the whole profit will be taxed. Hence, its entire income will be levied in the Netherlands.

4.6.2.1 Substance issue

Conform Article 9a of ATAD, the partnership is a *tax resident* for Dutch tax purposes, a separate entity. So, the CV is taxed accordingly on its income. Also, the partnership is able to enter into rights and obligations and is liable for its commitments. From my view, this is in conflict with economic reality since the CV has no legal personality or in capital divided shares. In fact, the participants are jointly liable for the obligations of the CV. The partnership is more an alliance between participants but, nevertheless, is considered as an independent stand-alone entity as from 2022. Moreover, the fact that the entity resides as such, does not imply it produces income. Being a resident for Dutch CIT is insufficient. The place where relevant business activities are performed that adds value, should be taxed. I believe it is obvious the CV does not really perform activities. Instead, the US participants are adding value since they grant excess cash to the CV originating from the US, or elsewhere. Even if one may argue that cash is generated at the level of the CV, ultimately the US participants are bearing the risks of providing cash. Their decisions are key. In addition, the US participants as recipients have a qualifying interest in the CV to (in)directly influence the decisions of the CV and, hence, its activities. Therefore, I assume that management decisions are also taking place in the US. In short, taxation should take place at the level of the US participants since this is more in line with the source principle.

4.7 The impact of ATAD 2

ATAD 2 will be implemented in two phases. Initially, on 1 January 2020, the regular hybrid entity provision is applicable. This means that Article 9(2)(a) will deny deduction of payments to a CV since the lex-specialis Article is not implemented. And, as from 2022, Article 9a of ATAD will enter into force.

As a result, *in 2020 and 2021*, the Netherlands treats the CV as a *transparent entity* under its tax law. The payments from the BV to the CV would still produce a D/NI outcome in which Article 9(2)(a) could be invoked. Any deductions of payments by the BV to the CV will, hence, be denied in the Netherlands. *As from 2022*, the deduction will no longer be denied because of Article 9a of ATAD. This measure treats the CV as a *taxable entity* under Dutch law and is, therefore, resident in the Netherlands. The US (state I), where the partner with more than 50% voting rights is residence, treats the CV also as a taxable entity of the other state (II), the Netherlands. The income of the CV will be taxed under Dutch tax law, if not otherwise taxed in (US) state I, the payments to the BV are deductible by the BV. It is possible that other MSs could implement ATAD before those dates. The payment from another MS to the BV would be

[150] Article 12aa(1) deny the deduction, and Article 12ab CIT 1969 include the payment in the income if not deducted.
[151] Consultation, *Supra 114*, section 2-3. Also, “Anti-Tax Avoidance Directive 2 (ATAD 2)”, Kluwer V-N 2017/36.3, pag.21/24.
[152] *Ibid*, Article 2(3) CIT 1969 includes partnership as a national tax liable entity in relation with Article 2(12) CIT 1969 which specifies the definition of the reversed hybrid. Other articles, however, neutralizes the mismatch outcomes.

denied in the other MS based on Article 9 of ATAD since the mismatch is not neutralized in the Netherlands.

Hereafter, the tax treatment of the CV used for licensing or financing activities, or for repatriation will be discussed separately since the outcome may differ.

4.7.1 CV/BV Structures and Licencing or Financing payments

In 2020 and 2021

The US parent company provides cash or licenses IP to the CV, which in turn, grants loan or licences the IP to the BV. The BV provides sublicenses or loans to other group entities. The difference between the royalties the BV receives and pays to the CV will be levied with Dutch CIT. As from 2020, due to Article 9(2)(a) of ATAD, the royalties paid by the BV is non-deductible, and the received royalties are included in its income. Thus, the BV will be taxed on the gross amount of the royalties against 22.55% in 2020 and 20.5% in 2021[153].The same applies for interest payments.

After 2022

After the reverse hybrid entity provision enters into force, the interest and royalty payments are, once again, deductible at the level of the BV. The CV as a taxable entity is tax liable for its interest or royalty income, while the BV pays Dutch CIT of 20.5% on the spread between the income and expenses[154]. It is not certain whether a step up would be granted to the CV relating to the IP. But according to Dutch tax law, the assets of the CV are revalued to fair market value and can be depreciated. So, the higher value of the IP will be taxed and is compensated by a corresponding increase in depreciation of the IP. The latter would decrease the effective tax burden on royalty income. Finally, the capital results in subsequent years will also be taxed. On the other hand, there is no depreciation on financing activities with the result that the interest of the CV would be taxed entirely.

4.7.2 CV/BV Structures and Dividend repatriation

In 2020 and 2021

Since the policy statement[155] under the Dutch-US income tax treaty in 2020 will be *repealed,* the US participants are *not* able to invoke the treaty benefits in which the reduced rate for dividends applies. The BV, obtaining the dividends from other group entities, usually applies the participation exemption. The moment the dividends are transferred by the BV to the CV, the dividends are taxed with 15% WHT since the US partners are the beneficial owners, not the CV. In 2020 and 2021, Article 9(2)(a) of ATAD have no effect on CV/BV structures since this neither results in a D/NI outcome nor payments are deducted from the taxable base of the BV.

After 2022

As described before, dividend repatriation with the use of a CV/BV structure, does not result in a D/NI outcome. Under Dutch law, the dividends received by the CV should be exempt from WHT[156]. However, Article 9a(1) of ATAD considers the CV as a Dutch tax resident and the received dividends are taxed to the extent that it is not taxed otherwise. So, this provision disallows the CV to apply the exemption and

[153] www2.deloitte.com, Belastingplan 2019.
[154] *Dutch:* Besluit Minister van Financien (Policy Statement Ministery of Finance), 27 March 2017, pag. 37-38. The remuneration which the BV pays to the CV is given as follows: the difference between the receiving payment from other entities and the distributed payment to the CV, minus the interest margin (also called the “spread”).
[155] Policy Statement of 6 July 2005.
[156] Article 4(1) Withholding Tax Act 1965.

the dividend distributions should, in principle, be taxed with 15% WHT. At the level of the BV and under the Dutch tax law, the dividends paid to the CV are exempt from WHT[157].

4.8 The US Tax Cuts and Jobs Act 2018

Under the new tax regime of 2018, the tax incentive for a CV/BV structure has significantly decreased, partly due to the introduced CFC-legislation in the US. While ATAD deals with hybrid mismatches, the US Tax Reform prevents US companies deferring taxation on their profits. This is enabled by replacing the nationality principle with the *territoriality principle*. The latter ensures that offshore US profits are included in the taxable base, whether repatriated or not. In addition, the reduced rate of *21% CIT* applies.

A distinction must be made between the foreign profits *after 1 January 2018,* and the *deferred* foreign income *between 1986 and 2018*. The deferred profits are imposed with 21% CIT in the US with the so-called *Transition tax*. Also, a credit will be applied for the tax paid in other states. Those pre-2018 profits are deemed to be repatriated to the US prior to the implementation of the *participation exemption* in 2018. The latter establishes that foreign dividends paid to *US participants* are 100% deductible. The exemption applies if the *US shareholder* has a *minimum ownership of 10%* in a foreign corporation, or the *US company* has *more than 50%* interest in this entity. In the latter case, this entity is regarded as a Controlled Foreign Company (CFC) which is situated in a low tax state.

In 2018, also the *Global Intangible Low-Taxed Income* (GILTI) is introduced which concerns IP. The royalties are not exempt but included in the taxable base, reduced with 50%, and then 21% CIT is imposed. In addition, a 80% credit is given for the foreign tax that the US investor paid in the other state, the Netherlands. This results in an effective tax rate (ETR) of 13.125%[158]. Finally, the royalties are only *exempted* in the US on condition that the ETR of the foreign tax amounts *more than 13.125%.* Remarkable is that, the lower the ETR imposed on foreign income in other states (below 13.125%), the more the ETR in the US increases. This way, US MNE's will repatriate their income to the US where both its taxable base is protected and their total ETR is minimised.

In this context, it seems to me, that the tax incentive to set up a CV/BV structure becomes less attractive as a result of (1) taxing the pre-2018 profits of the CV in the US with 21% CIT; and (2) since 2018 (US) exemption for repatriated dividends; and finally, (3) royalties favourable taxed in the US, whether distributed or not to the US. In addition, the Netherlands is taxing the income of the CV, after the adopted ATAD 2, irrespective received or not by the US participants.

4.9 Interim conclusion

The Netherlands is planning to implement ATAD 2 into their tax law as from 2020, except the reverse hybrid mismatch provision, "subject-to-tax-measure", in 2022. I believe that ATAD 2 has a substantial impact on CV/BV structures in the Netherlands. As it is well known, many US MNEs are using such structures to create a D/NI outcome caused by classification differences of entities between the US and the Netherlands. In 2020 and 2021, the CV is still a transparent entity and the outcome will be neutralized with article 9 by disallowing the BV to deduct its interest and royalty payments to the CV. As from 2022, however, the deductions are permitted but the reverse hybrid entity is subject to Dutch CIT. It is remarkable that the strategy of both articles differs. The reverse hybrid mismatch measure seems to me a

[157] Article 4(1) and see (10) Dividend Withholding Tax Act.

[158] E.g. Received royalty income (GILTI) amounts 120 and foreign tax paid in the Netherlands is 15. The effective CIT rate in the US is calculated as follow: GILTI tax = (120 -50%x120)x 21% = *12.6*. Foreign tax credit = *15*x80% = *12*. GILTI tax – tax credit = 12.6-12= *0.6* total tax burden. Effective tax burden GILTI= (15+0.6)/120 = 10.5%. The total effective tax burden amounts between 10.5% and 13.125%. However, the *50% reduction* will decrease to *37.5% in 2026*, the effective tax rate increases to *16.406%* as from 2026.

better solution since the problem is solved by its cause, the other is more focussed to neutralize the outcome. The Netherlands would, accordingly, impose tax on royalties and interest income of the CV if it is not taxed in the other state – in the hands of the US participants. This is interesting since BEPS Action 2 recommends to deny a deduction, while article 9a of ATAD 2 goes further by reclassifying the reverse hybrid entity in a taxable entity being more effective. An unequal level playing field will be created. On top of that, it may result in unintended mismatches which, due to the slow European bureaucratic system, requires a lot of time being neutralised. I believe that it would be an improvement if the Dutch government also orientate on foreign implementation to avoid such issues.

Another problem, is that ATAD should not affect the Dutch-US Tax Treaty. As a result, the subject-to-tax measure may not be applicable since the Treaty exclude transparent entities as tax residents, whereas ATAD is quite the opposite. So, under this Treaty the CV may have no treaty protection.

Nevertheless, there have been significant political developments in the US due to the Tax Reform of President Trump in 2018. The "old" check-the-box system, which made it possible to defer taxation on US profits deposited in the CV, was replaced with the CFC regulation in 2018. Before 2018, the US participants would only be taxed if the profits were repatriated resulting in a D/NI outcome. Now, the Tax Regime allows the *Transition Tax* to tax those profits which were not repatriated in former years against a reduced tax rate. Next, the *participation exemption* exempts the profits from US WHT, repatriated or not. An exception is made regarding income received for (sub)licensing of IP which is not imposed with an ETR of 13.125%. This *GILTI measure* has also an impact on the CV/BV structure. This measure will tax the royalties if the foreign (Dutch) ETR is below 13.125% which is, from my view, mostly not the case. So, the royalties are taxed at least once, if not sufficiently, the US will tax in addition. This way, the CV/BV structure already became less attractive since the US neutralised the hybrid mismatches from its perspective in 2018. I agree with the US approach to include the income in the hands of the US partners. This better reflects where economic activities takes place and value is added. In fact, the CV is used as a passthrough entity transferring the excess cash originating from the US partners. Their decision is key and they are bearing the related risks. Additionally, applying article 9a of ATAD 2 and the CFC rules (US) simultaneously may cause double taxation which could be resolved by means of a relief in the US.

In the same vein, article 9a of ATAD 2 will tax the income of the CV if not otherwise taxed at the level of the US participants. Even though ATAD does not concern tax rate differences, it attempts to neutralise the mismatch outcomes. Both the US and the Netherlands will influence the incentives of MNEs to set up such structures by applying approx. similar corporate tax rates. This may improve the level playing field.

All in all, the CV/BV structure may be old news and the US keeps its own course. As a response, MNEs could search for new structures including tax advantages that are more BEPS 2/ATAD 2-proof. Or, I could imagine that MNEs will focus on tax planning based on international tax rate differences. Further, companies could replace the transparent entity with a taxable entity in a low taxed jurisdiction which creates a milder version of the CV/BV structure. In this respect, the envisaged proposal of the Netherlands to implement the conditional source taxation on interest and royalty payments should not be neglected. Finally, applying Article 9a in relation with the recent introduced Multi-Lateral Instrument (MLI) may raise some concerns since the US does not have a similar measure and is not a party of the MLI. Probably, the OECD MC will be used for potential issues.

In conclusion, the implementation of article 9a of ATAD 2 has the desirable effect in the Netherlands since the mismatches are solved by its cause, albeit obsolete. So, a D/NI outcome no longer exists.

Chapter 5 The Effectiveness and Alternatives

As illustrated in chapter 4, the application of ATAD in the Netherlands will have impact on CV/BV structures. However, this chapter argues the alternatives for Article 9a of ATAD 2 and whether these methods are more efficient than ATAD 2 proposed solution for reverse hybrid entities. In fact, this measure targets the core issue of hybrid entity mismatches, i.e. the disparate tax characterization of entities. For this reason, three alternatives are provided. In section 5.1, *Article 62(1) of the EU CCTB* Proposal is examined. Next, whether a *common criteria for non-transparency* is a proper solution for hybrid mismatches (5.2). Finally, the relevant provisions of the *Multilateral Instrument* are demonstrated in section 5.3. In all cases, coordination between States is vital. Therefore, the *conclusion* (5.4) will present which method is a suitable alternative for the reverse hybrid entity provision of ATAD 2.

5.1 Article 62(1) of the EU CCTB Proposal

Article 62(1) of the CCTB Proposal grants supremacy to the tax characterization of the home State which may be an alternative for the OECD or ATAD linking rules. The reason for this rule is to avoid confusion whether the State where the entity is organized is a source State or a home State. The rule states that: *"Where an entity is treated as tax transparent in the MS established, a taxpayer holding an interest in the entity shall include its share in the income of the entity in its tax base"* [159].

This implies that if two States give a different tax qualification to the same entity, the tax treatment of the State where the entity is legally and formally established or incorporated should be followed by the other State, i.e. the home State. This coordination rule covers both EU and non-EU taxpayers (investors) holding an interest in a EU transparent entity in which their percentage of ownership is irrelevant. This is positive since the effectiveness of this rule is based on the extended scope. This measure applies only to reverse hybrid entities similar as Article 9a of ATAD, however, under another approach. The ATAD rule grants the supremacy to the tax characterization of the State where the larger part of the investors are tax resident[160].

Article 62(1) has the effect that if the reverse hybrid entity (Dutch CV) receives deductible payments - from the BV - those payments will be considered as income of the (US) investors in the other State without the application of CFC rules. Since the Netherlands is treating the CV as tax transparent, the US is therefore, required to consider the same entity also as fiscally transparent. This way, the hybrid mismatch is solved and the CFC rule is not required in this respect. Equally, it proves also that coordination results in single taxation.

This coordination rule may raise some doubts. First, if the reverse entity makes a payment to the BV or to a third country, this may be deductible at the level of the investors. Generally, in absence of this rule the investor State treats the entity as opaque and a deduction would not occur. Further, a payment by the same entity to the investor State would be disregarded for tax purposes. So, no deduction in the home State, nor an inclusion of income in the investor State. Therefore, if such benefits arise there should be a possibility to turn off this rule in case of the opposite effect or if the rule fails to have the desired result.

Ultimately, *this provision eliminates the hybrid mismatch* and it has a non-deduction/inclusion outcome, i.e. the payment of the CV to the investor State is not deductible and the interest is considered income of the BV (or third State). However, this coordination rule shall be *more effective if applied worldwide*.

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[159] EC, Proposal for a Council Directive on a Common Corporate Tax Base, COM (2016) 685 final, (25 Oct. 2016, Art. 62(1).
[160] Leopolda Parada, Intertax 2019, Volume 47, Issue 1, *Hybrid Entity Mismatches: exploring three alternatives for coordination*.

5.2 Common criteria for non-transparency

As already appeared in ATAD, MSs can decide autonomously how to qualify foreign partnerships, transparent or non-transparent. This is the main cause of the existing mismatches between national laws of MSs. And, since prevention is better than cure, preventing such differences may be possible if all States apply a common criteria for non-transparent entities.

It is notable, that the European Parliament also preferred for this option[161]. For this reason, the Parliament insisted that the EC came up with a proposal to *harmonize the national definitions of transparent and non-transparent entities.* Apparently, they were aware that hybrid entity mismatches would be solved by harmonizing the way in which undertakings are qualified by different States. Nevertheless, ATAD has opted to address the undesirable outcomes, i.e. double non-taxation.

Once all States apply similar criteria for transparency and non-transparency in their domestic tax law, specific anti-tax avoidance rules such as article 9a of ATAD would be redundant, including the hybrid entity provision in tax treaties.

However, due to the sovereign powers of States this may be a problem. They are free to design its tax system in a way it considers most appropriate. Some countries want to attract foreign investors using qualification differences resulting in tax advantages in their jurisdiction. So, it will be an impossible task to enforce all States adopting a common criteria for non-transparency in their domestic tax law. It would be *more effective if applied by all States*.

5.3 Multilateral Instrument (MLI)

In order to solve hybrid mismatches, coordination is required to modify domestic law and tax treaties. For this reason, the MLI is relevant to prevent BEPS. This instrument published on 24 November 2016 need to amend the existing bilateral tax treaties preventing ATAD measures being ineffective. Also, both MSs have to sign for the MLI measures to be applicable. The specific MLI provisions to tackle hybrid mismatches are Articles 3 (*transparent entities*), 4 (*Dual resident entities*) and 5 (*Application of measures for eliminating double taxation*). Dual resident provision will not be discussed[162].

Article 3(1) MLI has the same terminology as Article 2(1) of OMC 2017 which states that: *" For the purpose of a Covered Tax Agreement, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the law of either Contracting jurisdiction shall be considered to be income of a resident of a Contracting jurisdiction but only to the extent that the income is treated, for purposes of taxation by that Contracting jurisdiction, as the income of a resident of that Contracting jurisdiction".*

This provision ensures that tax treaty benefits are granted to the extend the income is received by a resident of a contracting State that is *subject to tax*. Thus, not solely liable to tax or considered as the income of its residents. This may be an issue in case the resident State does not recognize the income which is taxed by the source State – e.g. capital gains, deemed dividends – independent who derives that income. The source State may not doubt the allocation of taxing rights in situations that the resident State exempts the income as such, regardless of its beneficiary. However, this provision does not solve all treaty related problems regarding hybrid entities as clarified with the next example.

[161] European Parliament*, Report A8-0349/2015 with Recommendations to the Commission on bringing transparency, coordination and converge to Corporate Tax Policies in the Union*, (2015/2010/NL), Recom. C.6 Hybrid mismatches, p. 22.
[162] L.E. Schoueri & G. Galdino, Intertax 2018, Volume 46, Issue 2, *Action 3 and the Multilateral Instrument: Is the Reservation Power putting Coordination at Stake?*

Two US partners have an interest in entity X established in the NL. For Dutch purposes, the entity is tax transparent and non-transparent in the US. Entity X receives royalties from a Dutch BV in the same State. According to Article 12 OMC 2017, the US shall tax the royalties and the Netherlands is restricted in its taxing rights. Since, the US does not recognize the payments being received by its residents, the US will not tax the royalties. Article 3(1) MLI does not provide a suitable solution in such cases.

Article 5 MLI presents three options in case problems arise through the use of the exemption method incorporated in tax treaties regarding income not being taxed in the source State. These options originate from BEPS Action 2 Recommendations, Part II. With *Option A* the resident State does not apply the exemption method if the source State as a result of a qualification difference is not or less taxing the income. According to *Option B*, the exemption method shall not be applied but the credit method if the source State treats the dividend as deductible payments or interest. And, *Option C* replaces the entire exemption method with the credit method. A downside is that the State has the possibility not to apply this rule or blocking the other State with option C. So, the OECD Recommendations are a dead letter.

Although the MLI is an effective means to amend several tax treaties simultaneously without the need for separate negotiations between States, this instrument only works in relation with existing bilateral tax treaties as well as new tax treaties. Additionally, the States are required to sign for the MLI provisions being applicable. As shown, not all treaty related mismatches caused by hybrid entities are resolved. Further, those measures may be subject to *reservations* in which the effectiveness of the MLI may be undermined. Finally and quite relevant for this research, is that US is not a party of the MLI (*yet*). For all these reasons, *the MLI is not an effective way to solve the hybrid mismatch issues globally*.

5.4 Interim conclusion

This chapter analysed *three specific alternative paths for the reverse hybrid entity provision* in ATAD 2 (Article 9a). The results are surprising. First, *Article 62(1) of the CCTB Proposal* – recently presented in literature - in which supremacy is granted to the tax characterization rules in the home State to be highly effective and an attractive solution. Its applications is easy and the home State as the coordination country seems in a consistent way justified, as hybrid entity mismatches arise from disparate tax characterization of an entity. Additionally, it is applied in all cases of disparities between two or more States regarding the characterization of the same entity. However, it seems to me that the proposal raises some doubts about its effectiveness. The application of this rule may cause other undesirable outcomes. Yet, a coordinated application of this rule and CFC rules preventing double taxation when hybrid entities receiving payments, and the possibility to switch-off this rule in situations of tax advantage or disregarded transactions would have a positive impact. Still, a global, coherent and uniform adoption of this rule is crucial to promise a better result. A less effective alternative is *a common criteria for non-transparency* applied by States. This rule eliminates the cause of hybrid entity mismatches. Implementation appears to be efficient, only it seems to me an impossible task enforcing States to adopt the same rule in its domestic tax law. Finally, *the MLI* given its considerations regarding the reservation powers and some doubts, I think that the coordination being undermined. So, in practice it may not be effective since the signatory States show a limit commitment to these Articles. Most of them are using the reservation powers, so the provisions relating to transparent entities are ineffective. Also, the US is not a party of the MLI with the result that the MLI is not a suitable alternative.

As shown in this chapter, *coordination is vital*, irrespective which method is applied globally. None of these alternatives present a waterproof solution for reverse hybrid entity mismatches. Instead, it opens several debates what really matters to solve such mismatches *adequately* and *efficiently*.

Chapter 6. Conclusions & Recommendations

6.1 Introduction

After a headed debate regarding HMAs caused by autonomous application of different tax characterization of entities among countries, both the OECD and the EU took measures to counteract the undesired outcomes. This harms fair competition and the taxable base of States which gets substantial eroded and have a negative impact on the functioning of the internal market. For this reason, the OECD came up with BEPS Action 2 to neutralise the undesirable effects of HMAs. The OECD guiding principle was that *profits should be taxed where economic activities take place and where value is created*. The EU was quite enthusiastic with the OECD Recommendations and, therefore, came up with ATAD as a response. The implementation of ATAD is a considerable change, through coordination, which would improve the level playing field. It provides principle-based rules with a minimum protection to the corporate tax base of the MS.

Regrettable, the OECD and the EU deviated from the guiding principle and, instead, it has two approaches. Profit should be taxed where value is created- *the origin principle*-, and if not, than that profit should be taxed at least once – *the single tax principle*. As if matching the tax outcomes was the only way, the purpose was to ensure that double non-taxation would be prevented. Apparently, they are not concerned about other undesirable outcomes.

Initially, the Netherlands had some reservations due to US MNEs investing in the Netherlands by using CV/BV structures. The postponement of the implemented ATAD 2 measures was rejected. Additionally, the reverse hybrid entity measure was accepted and will have a significant impact on CV/BV structures.

Moreover, the question arises which alternative is the most suitable one. One may support the source principle or the principle of origin, or where the hybrid entity is located. The allocation of taxing rights should be allocated where income has been created due to an income-producing activity within the territory of that MS. It may decrease international juridical and economic double taxation, and ultimately aggressive tax planning will be reduced.

6.2 Conclusion

The fundamental research question of this Master thesis was:

“Does the proposed implementation of the anti-hybrid mismatch measure under ATAD 1 and 2 by the Netherlands solve the issue of reverse hybrid mismatches between the Netherlands and the United States legitimately and adequately?”

By means of the findings of this Master thesis, the following can be concluded (based on the sub-questions).

(i) Hybrid mismatches are arrangements exploiting differences in the tax treatment of entities and instruments between two or more States to achieve double non-taxation, including long term deferral. However, those mismatches between domestic tax laws can also result in double taxation *(chapter 2)*.

(ii) Under BEPS Action 2, the OECD identified the following types of mismatches: Hybrid financial instruments, Hybrid entity mismatches, Dual resident entities, Hybrid transfers and mismatches due to permanent establishments resulting in a DD or D/NI outcome *(chapter 2)*.

(iii) Apparently, ATAD is largely in line with BEPS Action 2 and closed many loopholes which are used by US MNEs due to aggressive structured arrangements. ATAD 1 was not extensive enough since *Article 9* only covered HMAs within the EU and excluded other types of mismatch arrangements. Therefore, ATAD 2 was extended and included its scope with reverse hybrid entities within and outside the EU (*Article 9(2) and 9a*). Equally, the secondary rule was lacking and included in Article 9(2). However, MSs have the option to exclude the secondary rule in some situations similar to Action 2. However, this does not apply for Article 9a since it treats transparent entities as tax residents in the State of establishment. Article 9 is based on chapter 4 of BEPS Action 2 (reverse hybrid entities), and I assume that the reverse hybrid entity situated in the EU of Article 9a is derived from the specific Recommendation 5.2 of the OECD Report. In fact, both are quite similar. The OECD and ATAD disregarded the economic reality since there is no (economic) substance in the CV. International allocation rules are not taken into account since the tax treatment of one State is dependent on the treatment of the same entity in another State by means of the linking rules *(chapter 3).*

(4) The Netherlands is planning to implement ATAD 2 into its tax law as from 2020, except the reverse hybrid mismatch provision *"subject-to-tax-measure"* in 2022. The latter provision assures that transparent entities are treated as a separate taxable entity for CIT, and are taxed accordingly. Even if the CV is not the beneficial owner – the risks are born and decisions are taken at the level of the US investors. It is strange to classify a partnership as a taxable entity since it cannot enter into rights and agreements. In 2020 and 2021, the CV is still a transparent entity in which Article 9(2) of ATAD need to be applied. The payments by the BV are not deductible. But as from 2022, the interest and royalties are deductible and included in the income of the CV. Where the *regular hybrid entity measure* recommends to deny a deduction, the *reverse hybrid measure* solves the mismatch by its cause. This creates an unequal level playing field *(chapter 4).*

(5) Whether the measure under ATAD 2 has the desirable effect depends on many factors. Before the US Tax Reform in 2018, the profits received by the CV were only taxed in the US if repatriated to the US, whereas at the level of the CV no taxation takes place. The US check-the-box system allowed US participants to defer taxation indefinitely. As from 2018, the income of the US participants are taxed under the CFC-rule in the US whether repatriated or not. Those profits are exempted but the income in former years are taxed against a reduced tax rate. The royalties, as an exception, will only be taxed in the US if the foreign (Dutch) ETR is below 13.125% ETR which is mostly not the case. So, the royalties are taxed at least once, if not sufficiently, the US will tax in addition. Due to the US Tax Reform, the CV/BV structure already became less attractive which neutralized the hybrid mismatch outcome before the ATAD is implemented in the Netherlands. The ATAD, on the other hand, see (4), neutralizes also the mismatch outcomes. I support the US approach to include the income in the hands of the US partners, as it better reflects economic reality. The CV has no substance and is used to transfer the excess cash originating from the US partners. Additionally, applying article 9a of ATAD 2 and the CFC rules (US) simultaneously may cause double taxation which could be resolved by means of a relief in the US. Also, the income of the CV is taxed if not otherwise taxed at the level of the US participants. This way, ATAD attempts to neutralise the mismatch outcomes *(chapter 4).*

(6) Finally, there were three alternatives presented for the reverse hybrid entity measure. A highly and effective method – most recent debated measure in the EU - is *Article 62(1) of the CCTB Proposal.* Since mismatches arises from disparate classification, the supremacy is granted to the tax characterization rules in the home State. In addition, States have the option to switch-off this rule in unwanted outcomes which did not exist in absence of this rule. Article 9a takes the same approach, yet supremacy is granted to the State where most of the investors are resident. Further a less effective measure is that States apply *a common criteria for non-transparency* but seems an impossible task enforcing all States to adopt this rule

in their domestic tax rule. Finally, also recently introduced is the *Multi-Lateral Instrument (MLI)*. However, this instrument may raise some concerns since the US does not have a similar measure and is not a party of the MLI. And, the MLI due to his reservation powers is not a suitable alternative. Of course, there are more alternatives which are not discussed in this thesis. The aforementioned methods are not perfect solutions for reverse hybrid mismatches but are discussions for further future *(chapter 5).*

Although obsolete due to the US CFC-regime since 2018, the anti-hybrid measure(s) under ATAD 1 and ATAD 2 in the Netherlands are solving the undesirable outcomes of CV/BV structures between the Netherlands and the United States legitimately and adequately since the mismatches are solved by its cause.

6.3 Recommendations

Although ATAD removes the cause of hybrid entity mismatches and the undesired outcome is being solved accordingly, some recommendations are presented in this respect.

(i) Based on multilateral collaboration between States, MSs should also take into account the tax characterization of entities in the other State. Instead of only concentrating on D/NI outcome. This implies that comparable features should be applied regarding partnerships. This way, a similar distinction is made between transparent and non-transparent entities.

(ii) In respect of reverse hybrid entities, MSs should tax in the jurisdiction where value is created and deduction should be granted where actual costs arise. In addition, the place where management decisions and risks are taken, and the place where relevant business activities are performed as well adds value. This is more in line with the source principle.

(iii) Finally, also in line with source taxation is that the secondary rule of Article 9(2) of ATAD should be applied *first* instead of the primary rule. As evidenced in recommendation (iii) and through the thesis, it is more likely that decisions and transactions takes place at the level of the partners in the US.

Although ATAD is on the right path and neutralizes the D/NI outcomes of reverse hybrid entities effectively, there are still some gaps resulting in tax arbitrage opportunities. Likewise, the question remains whether all MSs are implementing the same definitions and/or the same approach since ATAD provides minimum protection and is principle based. By harmonizing the definitions and more coordination among countries would decrease aggressive tax structures of MNEs.

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