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Proposed ATAD 2 hybrid rules in the Netherlands will have far-reaching impact

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The Dutch government recently published a bill implementing the second EU anti-tax avoidance directive (ATAD 2). Once enacted, the bill will effectively neutralise certain hybrid mismatch arrangements, which would otherwise result in double non-taxation. This bill takes effect as of 1 January 2020, with one measure – the reverse hybrid entity rule – becoming effective only as of 1 January 2022.

The bill and ATAD 2 will give rise to many complex questions in the context of sophisticated corporate and financing structures– in fact, such question have already arisen. It also appears that the Dutch government is seeking to implement ATAD 2 in a strict manner. This may result in double taxation or overkill. These two observations combined make the new hybrid mismatch rules a "trap for the unwary". To avoid these, taxpayers will need to carefully review existing structures and be mindful of the new hybrid mismatch rules when setting up new structures.

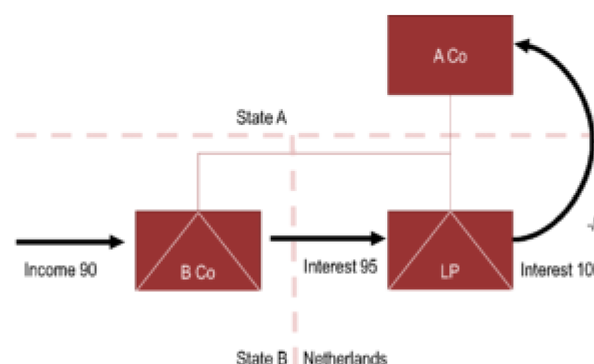
In broad terms, the implementing bill follows the approach used and the measures set out in ATAD 2, which, for its part, was inspired by action 2 of the OECD Base Erosion and Profit Shifting (BEPS) project. The hybrid mismatches addressed by these initiatives are "double deduction" and "deduction without inclusion" arrangements that (i) result from mismatches in the characterisation of entities, instruments or permanent establishments by relevant jurisdictions and (ii) arise between related entities or under a "structured arrangement". ATAD 2 and the implementing bill do not address other de facto mismatches such as transfer pricing mismatches (for example, the widely used Irish-Luxembourg interest-free loan structure) and non-taxation resulting from payments to exempt entities (for example, exempt pension funds). While there are notable exceptions, the general principle is that either a deduction of the relevant, actual or deemed, payment is denied (primary rule) or, where the country of the payor does not disallow the deduction, the relevant income is included (secondary rule).

The way the Netherlands has implemented the hybrid rules may make the new rules a "trap for the unwary". First, the implementing bill and ATAD 2 will lead to – and, in fact, have already given led to – many complex questions about sophisticated corporate and financing structures. While the bill's official explanation and the BEPS action 2 report give extensive guidance, taxpayers will continue to have many unanswered questions. Second, on close examination of the bill, the Dutch government appears to implement ATAD 2 in a strict manner. This may result in double taxation or overkill.

The following selected features of the implementing bill illustrate these observations:

Double income inclusion

The explanatory memorandum to the bill stipulates that the rules should not cover arrangements where relevant income is effectively taxed once. Accordingly, in terms of potential "deduction, no inclusion" arrangements, the new hybrid mismatch rules provide that income can be deemed "included" even if it is not included in the direct recipient's taxable income, but is included in the taxable income of the recipient's direct or indirect parent. In addition, (ii) a hybrid mismatch payment is not neutralised by the bill to the extent that the income from which it is deducted is included in the relevant companies' taxable income twice ("double inclusion income"). While these exceptions may seem to indicate that the Netherlands is adopting a lenient approach, the explanatory memorandum to the bill suggests that these exceptions will be strictly applied. For instance, controlled foreign company (CFC) income taxed at a special rate does not qualify as included. In some cases, this seems at odds with the general comment in the explanatory memorandum that the application of innovation box and similar regimes does not impact the qualification as "included" income. This apparent contradiction raises the question of whether, for instance, income taxed under the US FDII regime qualifies as included, while income taxed under the US GILTI rules does not. CFC income for which a tax credit can be claimed is also disqualified. Another example is that consolidation of profits of Dutch and foreign group companies – for purposes of foreign CFC rules and the double income inclusion rules – disqualify the relevant income as included, even if effectively no double non-taxation occurs. The example below given in the official commentary on the double income inclusion exception illustrates this point.



Example 14 of the explanatory memorandum

In this example, B Co and LP are treated as transparent under the laws of State A, while being non-transparent under the laws of State B and the Netherlands. According to the explanatory memorandum to the bill, the assessment of dual inclusion income must be made between the two states involved in the hybrid mismatch outcome, that is, State A and the Netherlands. As such, in this example, there would only be dual inclusion income if the income received by LP – 95 interest – is taxed at the level of A Co. However, due to the transparency of B Co and LP, State A does not recognise the interest payment made by B Co to LP. Instead, A Co only taxes the 90 income received by B Co. Accordingly, the 95 interest received by LP is not "included" by A Co. This means,

according to the explanatory memorandum to the bill, that the income against which the interest payment of LP is set-off is not dual inclusion income. The fact that the income received by B Co is taxed at the level of A Co is irrelevant. By not taking into account the taxation of the income received by B Co, the dual inclusion income definition may result in de facto double taxation.

Structured arrangement

As set out in both ATAD 2 and BEPS action 2, the new rules also apply if the hybrid mismatch arises between unrelated parties in a "structured arrangement". The comments in the explanatory memorandum to the bill (and the BEPS action 2 report) are clear, and may be interpreted by the Dutch tax authorities as allowing a wide interpretation of this term, with corresponding far-reaching implications for taxpayers. One aspect that could give rise to discussions is that the explanatory memorandum to the bill stipulates that the existence of a structured arrangement does not depend on the parties' intentions. Rather, the term must be applied "objectively". No detailed guidance is provided on how to apply this objective test. In our view, a sensible interpretation is that there must be "objective intentions": where it can be derived from objective facts and circumstances that the structuring must have been aimed at the hybrid mismatch outcome, without having to show actual intentions. However, it remains to be seen whether this interpretation will be accepted by the Dutch tax authorities or whether, in practice, they will consider any arrangement that gives rise to a hybrid outcome as forming a structured arrangement unless a specific exception applies. This exception applies if the taxpayer could not be reasonably aware of the hybrid outcome and did not benefit from it.

Supporting documents

The explanatory memorandum to the bill stipulates that taxpayers must be able to provide documents supporting both the applicability and non-applicability of the hybrid mismatch rules. These documents should, for example, contain evidence of the tax treatment of the financial instrument, entity or payment in the recipient jurisdiction. To the extent that the documents do not provide sufficient support, the burden of proof shifts to the taxpayer whereby it is presumed that the hybrid mismatch rules apply. It is then up to the taxpayer to convincingly demonstrate that these rules do not apply. In practice, this means that taxpayers must assess and document the non-applicability of the new rules in respect of each otherwise deductible payment.

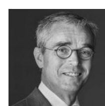
Stringent approach

The Dutch government has elected to include the optional secondary rule, and thus a more stringent application of ATAD 2 than required, in several instances. For example, in case of payments to reverse third country hybrids and hybrid mismatches with regard to permanent establishments. Additionally, hybrid transfers of securities made by financial traders acting in the ordinary course of business have not been excluded from the application of the hybrid mismatch rules.

In terms of the Dutch tax treatment of partnerships, the Dutch government announced in the explanatory memorandum to the bill that it will investigate changes to the current criteria for the Dutch tax classification of foreign entities and partnerships. The current criteria are unique to the Netherlands and, therefore, classification mismatches often arise in the context of cross-border partnership structures.

Finally, despite the fact that the reverse hybrid rule will not become effective until 1 January 2022, the Dutch government has announced that the unilateral policy decision (based on which dividends and other income derived from shares in Dutch companies by US resident participants in reverse hybrids, including CVs in CV/BV structures, can benefit from benefits under the tax treaty between the US and the Netherlands) will be revoked as of 1 January 2020. As a result, treaty benefits will no longer be available as of 1 January 2020 pursuant to article 24, paragraph 4 of the treaty and, among other effects, dividends will be subject to 15 percent Dutch dividend withholding tax.

Experts



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