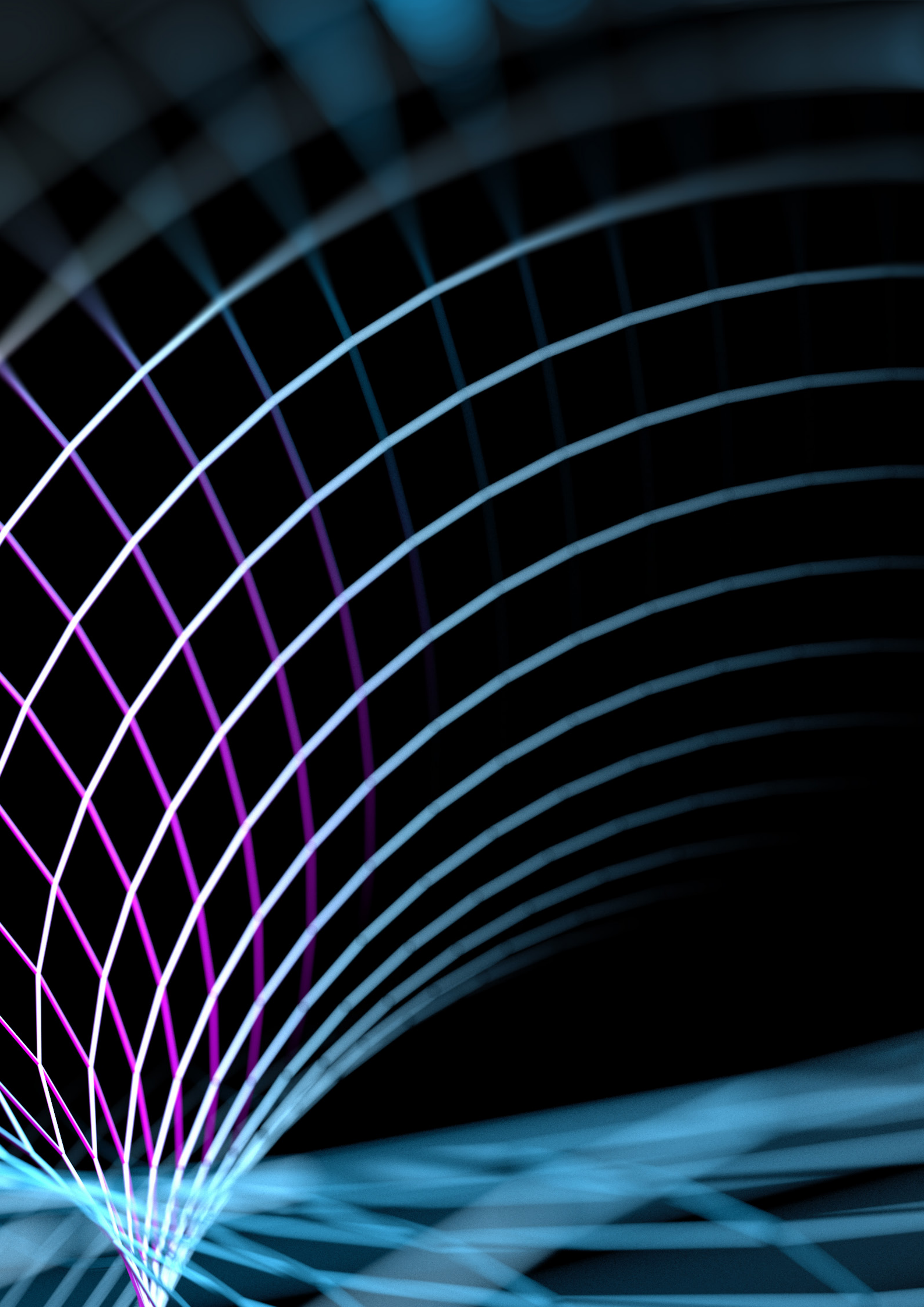
Dutch Anti-Hybrid Rules 2020



This alert summarizes the technical and practical implications of the Dutch Anti-Hybrid Rules. We specifically address the potential overkill that applies to US multinational companies with entities in their structure that are 'checked' as disregarded for US federal income tax purposes.

On 17 December 2019, legislation implementing the EU Anti-Tax Avoidance Directive 2 (“ATAD 2”) in Dutch tax law has been adopted and will have effect as of 1 January 2020 (i.e. financial years starting on or after 1 January 2020). All EU Member States are obliged to implement ATAD 2.

Important takeaways

- All Dutch corporate income taxpayers are obliged to document why the Dutch Anti-Hybrid Rules do not apply or how they have been applied. Not complying with this documentation requirement could ultimately result in an increased burden of proof for the Dutch corporate income taxpayer to demonstrate that the proposed rules do not apply or are sufficiently applied.
- Under the Dutch Anti-Hybrid Rules, a Dutch subsidiary of a US parent company, for example a Dutch BV (besloten vennootschap), which is checked as a disregarded entity for US federal income tax purposes qualifies as a so-called "hybrid entity". When deductions claimed by the Dutch BV are also deductible at the level of the US parent, this would in principle lead to a 'double deduction'. If a 'double deduction' is not neutralized by 'double inclusion' income, the deduction may be denied under the Dutch Anti-Hybrid Rules which could result in substantial overkill. If the income of the Dutch BV consists of payments from its US parent or a disregarded group company, this would in principle not lead to 'double inclusion' income. We therefore recommend carefully reviewing whether disregarded Dutch entities in your structure will fall in scope of the Dutch Anti-Hybrid Rules potentially leading to a denial of deductions claimed in the Netherlands.
- The combination of CFC-rules and the Dutch Anti-Hybrid Rules could result in double taxation of income. This is recognized by the Dutch government, but in many situations not neutralized due to the prohibitive nature of both rules. If it is expected that an entity in your structure will be subject to this double taxation, it may be beneficial to restructure on short term.
- In the Dutch Senate, a motion has been adopted requiring the Dutch government to develop policy that should as much as possible prevent that taxpayers are double taxed as a result of the implementation of the EU Anti-Tax Avoidance Directives in Dutch tax law. Although the motion does not provide concrete guidance, we are hopeful that the Dutch government will indeed prepare mitigating policy for situations where the Dutch Anti-Hybrid Rules would result in overkill.
- The Dutch Anti-Hybrid Rules are applicable with respect to affiliated entities[1]. However, the Dutch Anti-Hybrid Rules could also apply between third parties due to the structured arrangement rule. A structured arrangement is an arrangement that results in a hybrid mismatch and in which the benefit of the hybrid mismatch is factored in, or where the hybrid mismatch is the result of an arrangement that is designed to result in a hybrid mismatch outcome. There is no structured arrangement if the taxpayer or an affiliated entity thereof cannot reasonably be expected to be aware of the hybrid mismatch and if they do not benefit from the hybrid mismatch.

1. Entities qualify as affiliated if there is a shareholding relationship of at least 25%. Entities also qualify as affiliated entities if they for example are part of the same consolidated group for accounting purposes or if one of the entities exercises a significant influence on the management of the other entity.

The Dutch Anti-Hybrid Rules

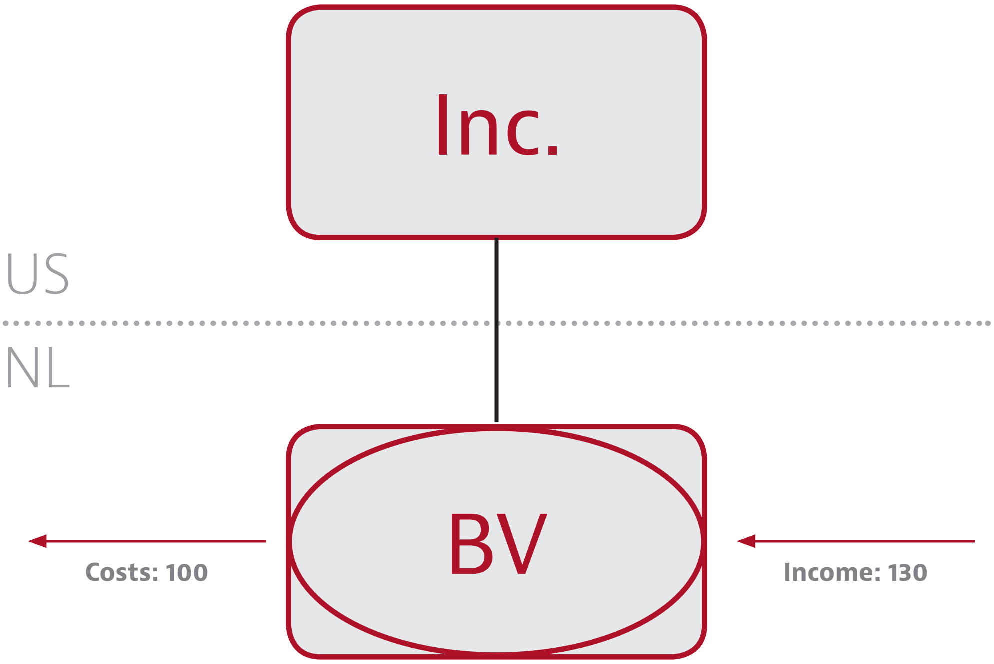
The Dutch Anti-Hybrid Rules are aimed at neutralizing hybrid mismatches between associated enterprises that result in deduction/non-inclusion or double deduction outcomes through the following rules:

- Deduction/non-inclusion ("**DNI**") situations (effective 1 January 2020): the primary rule provides that a Dutch taxpayer being the payor cannot deduct a payment if this payment is not included in taxation at the level of the payee, and the cause of the non-inclusion at the payee level is a hybrid mismatch. Under the secondary rule, where the Dutch taxpayer is the payee, any income of that Dutch taxpayer that would normally have been exempt will in principle be taxed in the Netherlands if the State of the payor allows for a deduction in a hybrid mismatch situation.
- Double deduction ("**DD**") situations (effective 1 January 2020): the primary rule provides that a Dutch taxpayer cannot deduct a certain payment if this payment can also be deducted in another State as a result of a hybrid mismatch, and that other State can be regarded as the payor State. If the Netherlands is regarded as the payor State, the deduction is allowed at the level of the Dutch taxpayer as long as the other State in fact disallows the deduction. The payor State is the State in which the payment arose or in which the expenses or losses are incurred.
- Reverse hybrid entity rule (effective 1 January 2022): Reverse hybrid entities are entities that are held for 50% or more by participants in (a) State(s) that consider(s) the entity as non-transparent whilst the entity is considered transparent in the State in which the entity is incorporated, established or registered. Under the Dutch Anti-Hybrid Rules, such entities should be subjected to tax in the State of incorporation, establishment or registration.

The Dutch Anti-Hybrid Rules only apply if there is a DD or DNI situation, as explained above. If, however, such situation is neutralized by double inclusion ("**DI**") income, the consequences of the Dutch Anti-Hybrid Rules should generally not apply.

Example of Double Inclusion income

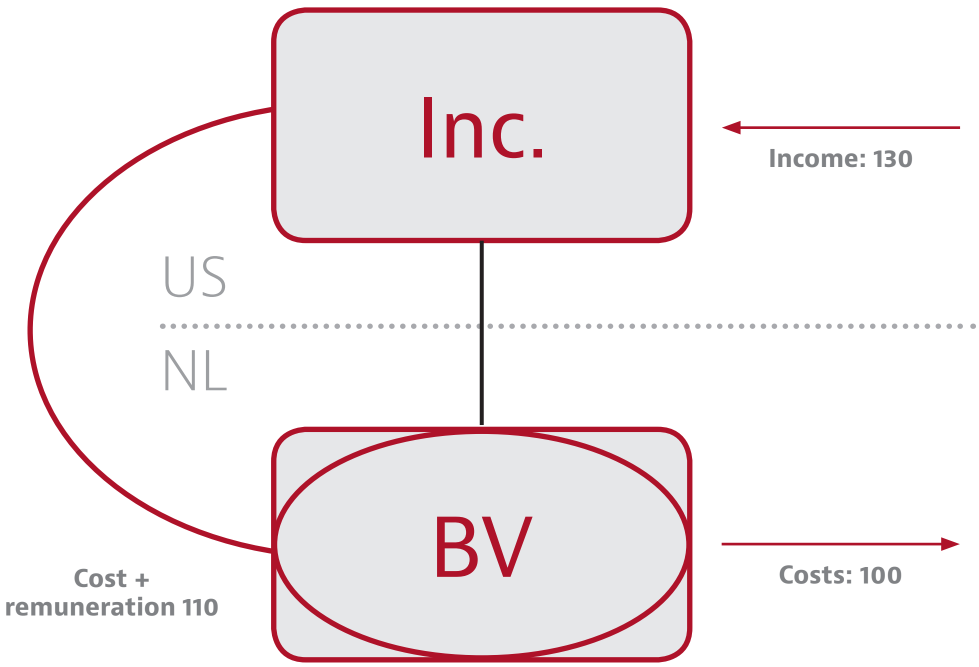
If a US Inc. owns all the shares in a Dutch BV which is checked as a disregarded entity for US federal income tax purposes, the Dutch BV in principle qualifies as a hybrid entity subject to the Dutch Anti-Hybrid Rules. Because expenses incurred by the Dutch BV are deductible both in the US and in the Netherlands, there will be a DD situation. To the extent that the fact that the Dutch BV is disregarded causes its income and expenses to be subject to taxation both in the Netherlands and in the US, the Dutch Anti-Hybrid Rules prescribe that the tax benefit arising from the hybrid entity should be considered neutralized and therefore, the Dutch Anti-Hybrid Rules should not apply. Notwithstanding that the US Inc. can credit Dutch corporate income taxes paid to offset its US federal income tax burden, the income can still be regarded as DI income.



The costs of 100 are deductible both in the US and in the Netherlands. Therefore, in principle the Dutch Anti-Hybrid Rules deny the deduction of the costs at the level of the BV. However, if the income of 130 is also effectively included in Inc.'s income in the US as well as in the Netherlands, the Dutch Anti-Hybrid Rules should not deny the deduction of the costs. The income of 130 can still be regarded as DI income in the situation where the Inc. can credit the Dutch corporate income tax on the profit of the BV (30).

Example that is not considered Double Inclusion income

A US Inc. owns all the shares in a Dutch BV, which is checked as a disregarded entity for US tax purposes (i.e. a hybrid entity). If the Dutch BV incurs costs for routine functions for which it is being reimbursed by its US parent company under a cost-plus arrangement with that US parent company, such costs are effectively deductible both in the US as well as in the Netherlands. However, because the cost-plus remuneration of the Dutch entity is not recognized in the US due to the Dutch BV being disregarded, the DI exemption does not apply. Consequently, costs incurred by the Dutch BV may not be deductible, which would result in substantial overkill. The Dutch Secretary of Finance acknowledged that this may be an undesired outcome, but stated that there is no room for other interpretation of Dutch Anti-Hybrid Rules and the prohibitive nature of the anti-avoidance rules do not warrant specific rules preventing this outcome.



The costs of 100 would in principle be deductible both in the US and in the Netherlands and therefore qualify as DD. The income of 130 is included in taxation in the US. The cost plus remuneration of 110 is included in taxation at the level of the BV in the Netherlands. However, the remuneration of 110 is not recognized in the US. This situation is therefore not regarded as a DI situation and consequently the deduction of 100 is denied in the Netherlands and BV is subject to tax in the Netherlands on 110 of profit. This results in substantial overkill since the taxable base in the Netherlands (i.e. 110) is more than the stand-alone profit of BV for statutory purposes (i.e. 10) or the consolidated profit of the group (i.e. 30).

Examples of hybrid mismatches

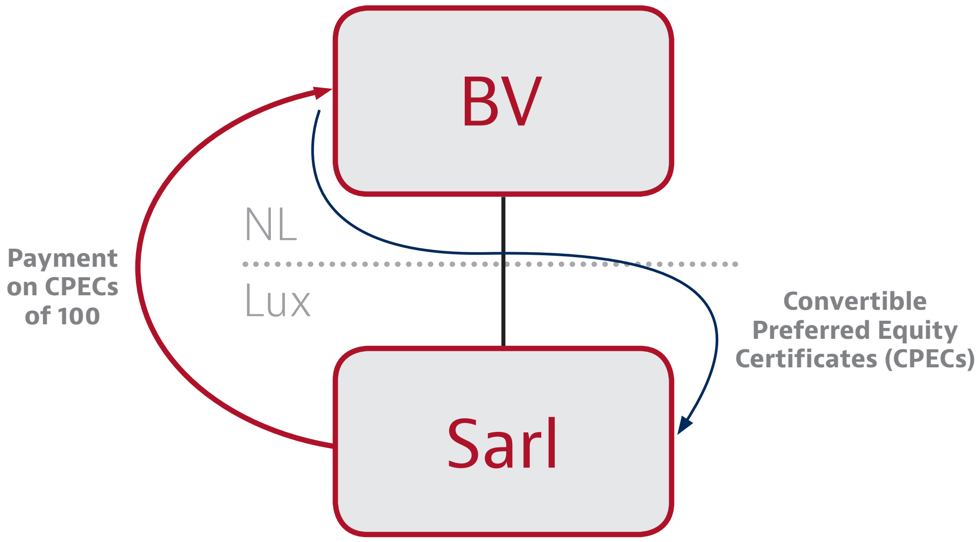
The explanatory notes to the Dutch Anti-Hybrid Rules cover the following examples that may result in either a DD or DNI outcome following a hybrid element:

- **Hybrid entities:** The States are not aligned on the qualification of an entity as opaque or transparent for tax purposes, resulting in a DD or DNI outcome. An example is the Dutch CV/BV-structure.

  However, if for example a payment is made to a hybrid entity which results in a DNI situation, but a DNI situation would have existed regardless of whether there is a hybrid element, the Dutch Anti-Hybrid Rules should not apply. This means that if the payment is not included in taxation due to the fact that the State of which the hybrid entity is a tax resident either has no profit tax, or exempts such entity from profit tax or applies a special regime, the DNI situation does not follow from a hybrid mismatch as such and the Dutch Anti-Hybrid Rules should not apply.

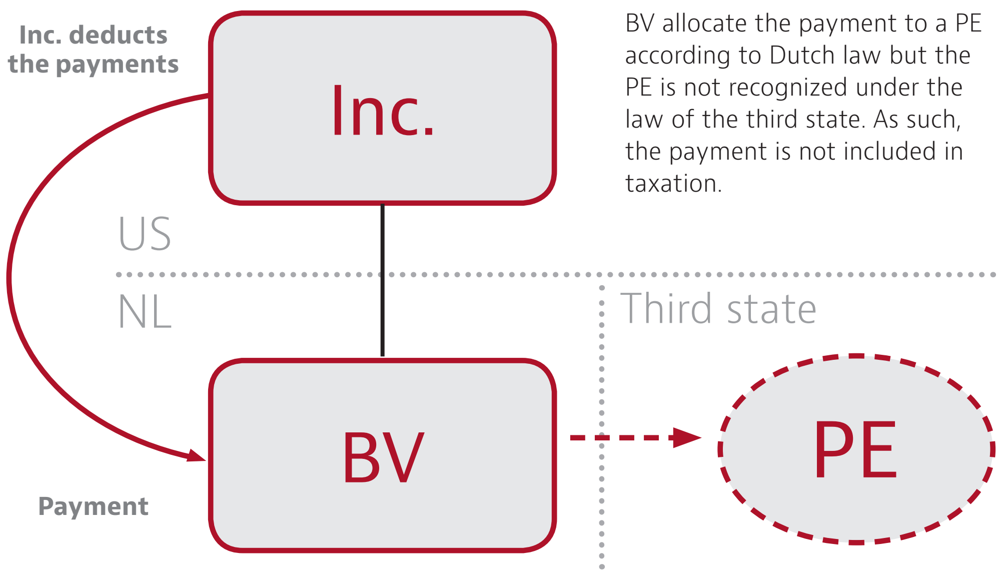
  Under the reverse hybrid rules, Dutch CVs that are considered non-transparent entities from a foreign perspective, whereas the CV qualifies as transparent for Dutch tax purposes, will be become subject to Dutch corporate income tax. A reverse hybrid entity will get a step-up in value of its assets for Dutch tax purposes at the moment it becomes a tax resident of the Netherlands. An exit tax will apply at the moment the entity is no longer regarded as a reverse hybrid entity. Ultimately before 1 January 2022, additional rules for reverse hybrid entities will be published in a separate legislative proposal.

- **Hybrid financial instruments:** The States involved are not aligned on the qualification of the instrument and therefore payments could for example be deducted by the payor and exempt at the level of the payee. The hybrid mismatch should follow from the qualification of the financial instrument. If for example an exemption applies due to the qualification of the financial instrument, a payment on such instrument could result in DNI situation following from a hybrid element.



If a CPEC is re-characterized as equity for Dutch tax purposes, payments on such CPECs are regarded as dividends from a Dutch perspective and as interest from a Luxembourg perspective. Hence, the payment of 100 would be deductible at the level of SARL and in principle exempt at the level of BV. Under ATAD2, SARL cannot deduct the payment of 100. If the payment is nevertheless deducted at the level of SARL, the Dutch participation exemption is denied and the income would be taxable at the level of BV. This situation was already caught under anti-abuse provisions in the participation exemption.

- **Hybrid permanent establishments:** States are not aligned on the allocation of payments to a permanent establishment or the recognition of a permanent establishment for tax purposes.



As the payment is allocated to the PE in the third State but not included in taxation in that State, the payment is deducted at the level of Inc., but would not be subject to Dutch tax at the level of BV. Under the Dutch Anti-Hybrid Rules, the object exemption is denied with regard to the payment. Hence, this payment should in principle be subject to tax at the level of BV.

- **Hybrid transfers:** States are not aligned on who is to be treated as the recipient of distributions arising from a financial instrument that is transferred.

- **Imported hybrid mismatches:** In this case a transaction that is taking place between residents of EU member States does not as such result in a hybrid mismatch, but that transaction is connected to another transaction with a third State that does not apply anti-hybrid rules, and so the effect of that non-EU hybrid mismatch transaction is "imported" into the EU.

  For a regular transaction to qualify as an imported hybrid mismatch, the regular transaction should be effectively "connected" to the hybrid mismatch transaction with the third State, based on the facts and circumstances. To determine whether there is such connection, for example the amount of the payment and that of the hybrid mismatch, the nature of the payment, the conditions that are taken into account between parties and the payment dates could be of importance. The "connection" should be broadly interpreted. If some formal conditions between parties are not the same, the situation could still qualify as an imported hybrid mismatch.

- **Dual residency:** An entity is treated as a tax resident in more than one State, resulting in double deduction of expenses, losses etc.

Documentation requirement

The proposed legislation includes a requirement for all Dutch corporate income taxpayers to document why the Dutch Anti-Hybrid Rules do not apply or how the rules were applied. Such documentation could for example exist of a worldwide structure chart, an assessment of the financial instruments used, foreign tax returns/assessments that show the treatment of the financial instruments, hybrid entities and permanent establishments, analysis of such treatments, and, if applicable, a calculation of the applied adjustment following the application of the anti-hybrid mismatch rules. If a Dutch corporate income taxpayer is only involved in transactions within the Netherlands, this should follow from its administration, which should be sufficient for the Dutch tax authorities to not apply the Dutch Anti-Hybrid Rules.

A hybrid mismatch could also exist between non-affiliated entities due to the structured arrangement rule. The Dutch government indicated that with regard to transactions between non-affiliated entities, the Dutch corporate income taxpayer does not have to include additional documentation in its administration. The taxpayer complies if the administration shows that there is no affiliation with the other party to the transaction. This administration is however not sufficient in case of non-affiliation, if the Dutch taxpayer deliberately allocated the tax benefit with regard to that transaction between itself and the non-affiliated party to the non-affiliated party.

If the Dutch tax authorities request information from the Dutch corporate income taxpayer, the Dutch tax authorities should grant the Dutch corporate income taxpayer a reasonable term (of a minimum of six weeks) in which the Dutch corporate income taxpayer should provide the documentation to the Dutch tax authorities.

If a Dutch corporate income taxpayer does not (sufficiently) comply with this documentation rule, and the Dutch tax inspector presumes that the Dutch Anti-Hybrid Rules are applicable, an increased burden of proof rests with the taxpayer to demonstrate that the proposed rules do not apply or have been sufficiently applied. However, the Dutch tax inspector should act within reason when asking the Dutch corporate income taxpayer for such proof. A taxpayer can rebut this presumption by demonstrating that it exercised reasonable required effort and it does not have access to the information concerned. The Dutch corporate income taxpayer is then not subject to the increased burden of proof.

Double taxation

As explained above, the adopted legislation potentially causes taxpayers to be subject to double taxation. In the Senate, a motion has been adopted requiring the Dutch government to try to prevent that taxpayers are in practice effectively double taxed as a result of the implementation of the EU Anti-Tax Avoidance Directives in Dutch tax law. Although this does not provide concrete guidance, we are hopeful that the Dutch government will indeed prepare mitigating policy for situations where the Dutch Anti-Hybrid Rules would result in overkill.

Baker McKenzie helps clients overcome the challenges of competing in the global economy.

We solve complex legal problems across borders and practice areas. Our unique culture, developed over 70 years, enables our 13,000 people to understand local markets and navigate multiple jurisdictions, working together as trusted colleagues and friends to instill confidence in our clients.

www.bakermckenzie.com