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Bill on implementation of ATAD2 presented to the Lower House

On July 2, 2019, the bill to implement the amendment to the EU Anti-Tax Avoidance Directive (ATAD2) was presented to the Lower House. As a result of this amendment, the Directive now combats both hybrid mismatches among EU Member States and between EU Member States and third countries. Please also refer to our previous memorandum in response to the political agreement reached in February 2017.

The content of the bill now before the Lower House is in line with the draft bill that was opened for public consultation in October 2018. The draft bill was extensively discussed in our memorandum on the consultation document. However, given the importance for the tax practice, the content of the bill now before the Lower House will again be discussed in detail below.

1 Implementation of ATAD2 in short

1.1 Hybrid mismatches

ATAD2 tackles tax avoidance via hybrid mismatches in affiliated relationships. Hybrid mismatches concern situations in which differences between tax systems are used with regard to the qualification of entities, instruments or permanent establishments. Hybrid mismatches may result in a tax deduction whereby the corresponding income is not taxed anywhere, or whereby the same payment is deducted several times.

The measures are not directed at mismatches that do not originate in a hybrid element. This is, for example, the case when the arm's length principle is applied differently between countries, or when a fee or payment is not taxed, because the entity is not subject to corporate income tax or the state has no corporate income tax.

The bill distinguishes between hybrid mismatches with:

- hybrid entities;
- hybrid financial instruments
- hybrid permanent establishments;
- hybrid transfers;
- imported hybrid mismatches;
- situations involving dual domicile.

In line with ATAD2, the consequences of these hybrid mismatches will be neutralized. Depending on the mismatch and the treatment outside the Netherlands, this occurs by refusing the deduction or taxing the income. The neutralization will only take place to the extent necessary to neutralize the mismatch (pro rata).

In the case of mismatches that result in a deduction without the corresponding payment being subject to tax (deduction no inclusion), the payment will not, primarily, be allowed to be deducted (primary rule). If the primary rule is not applied, the payment must be taxed at the recipient (secondary rule).
In the case of mismatches that trigger a double deduction, neutralization will take place by refusing the deduction in one of the countries. The deduction must primarily take

place in the payor's country. It will be refused in the other country. If the primary rule does not offer a solution, then the payor's country must refuse the deduction.

ATAD2 links the Dutch corporate income tax to the tax systems of other countries. As a result, international arrangements will become even more sensitive to regulatory changes in the various countries. The hybrid mismatch rules are discussed in more detail below. These will apply to financial years commencing on or after January 1, 2020.

Also, as of January 1, 2020, the policy statement on hybrid entities under the tax treaty with the United States will be withdrawn (Policy Statement of July 6, 2005, IFZ2005/546M). In short, this policy statement provides for the reduced rate on dividends in the tax treaty with the United States to be applied to CV/BV (limited partnership/private limited liability company) structures.

1.2 Reversed hybrids (CV/BV structures)

The bill also contains a *subject-to-tax measure* for 'reversed hybrid entities' such as in the CV/BV structure. This concerns entities that are not regarded as being subject to tax in the country of incorporation, establishment or registration (also referred to as 'tax transparent'), while being regarded as non-transparent in the country of the participants in the entity. If (a part of) the entity's profit is not subject to tax, then this will occur in the Netherlands if the entity is incorporated, established or registered in the Netherlands. The measure not only tackles the effect (neutralization), but also the cause (the elimination of the qualification difference). The reversed hybrid rules will apply to financial years commencing on or after January 1, 2022.

For the sake of clarity we would like to point out that, as of 2018, CV/BV structures had already become less attractive as a result of CFC measures in the United States and that as of January 1, 2020, payments to BV/CV structures could be affected by the abovementioned hybrid mismatch rules. As of January 1, 2020, the payments can be excluded from deduction. The subject-to-tax measure, which will apply as of January 1, 2022 and as a result of which income will be taxed in the Netherlands at the CV/BV, is additional to this. From that moment on there will of course no longer be a hybrid mismatch; after all the income is taxed at the recipient. A deduction limitation by virtue of the hybrid mismatch rules will then no longer take place at the paying company.

Other than in the draft bill, the bill now before the Lower House includes double tax relief rules under which the reversed hybrid entity is only effectively taxed in the Netherlands insofar as its profit is not taken into account at the participants. Also new in the bill is that designated undertakings for collective investment in transferable securities (UCITS) and alternative investment institutions will, under certain conditions, be excluded from the subject-to-tax measure.

The explanatory notes to the bill state that additional measures are being looked into in light of the subject-to-tax measure. This in any case includes a dividend withholding tax obligation for reversed hybrid entities.

1.3 Documentation obligation

Compared to the draft bill, the bill before the Lower House includes a new documentation obligation related to the hybrid mismatch rules. In short, a taxpayer who indicates in the tax return that the hybrid mismatch rules do *not* apply to it, must include information in its accounts and records showing this is the case. If a taxpayer *does* apply the hybrid mismatch rules in its tax return, it must include information in its accounts and records showing how the hybrid mismatches rules are applied. This can, for example, be a group scheme and a tax-legal assessment of the relevant financial instruments, hybrid entities and/or permanent establishments.

If a taxpayer fails to comply with the documentation obligation or only partly complies with it, it will be presumed that the hybrid mismatch rules apply. This means that a heavier burden of proof will come to rest on the taxpayer, because it must then be shown that the hybrid mismatch rules do not apply.

2 A closer look at the hybrid mismatch rules

2.1 Mismatch with hybrid entities

There is a hybrid entity if an entity is regarded as tax transparent in one State, but as non-transparent in the other State. This may result in neither of the states involved taxing the hybrid entity's profit, or in a double deduction being allowed.
The mismatches with hybrid entities can be divided into three main types:

a. payments to hybrid entities;
b. payments by hybrid entities;
c. situations involving double deductions.

The primary rule of the Dutch implementation of ATAD2 with regard to a. and b. will be that the payments are not allowed to be deducted. The secondary rule will be that the payment must be taxed at the recipient. The above can, for example, also mean that a Dutch entity subject to tax is transparent as a result of the qualification under foreign law and as such is regarded as a hybrid entity under ATAD2. In that case, a payment by, for example, a Dutch BV can thus be subject to a deduction limitation.

With regard to c., as primary rule the Netherlands will not allow the deduction at the investor and as secondary rule will not allow the deduction at the payor if it is permitted in the investor's State.

2.2 Mismatch with hybrid financial instruments

A financial instrument is any instrument that yields a return on equity or debt. There is a hybrid financial instrument if a State permits payments based on that financial instrument to be deducted from the profit, while the corresponding income is not taxed or not taxed within a reasonable period at the recipient as a result of a difference in the qualification of the fiscal instrument or the payment based on it. Hybrid financial instruments also include the hybrid transfer, which we will discuss separately below.

In order to determine whether the corresponding income is taxed within a reasonable period, the tax period at the recipient that begins within 12 months of the end of the tax period within which the payor has taken the deduction into account will be examined. If this is not the case, there can still be a reasonable period if the payment is expected to be taken into account at the recipient and the payment conditions for the hybrid instrument would also have been agreed by independent parties.

Based on the bill, the primary rule will be that payments are not allowed to be deducted. This is not expected to occur frequently in EU situations, given that the EU Parent-Subsidiary Directive also provides for an anti-abuse rule for hybrid financial instruments, on the basis of which the recipient of the payment cannot exempt it. The secondary rule will be that the payment must be taxed at the recipient.

2.3 Mismatch with hybrid permanent establishments

There is a hybrid permanent establishment if there is a difference of opinion between States about the presence and/or attribution of profit to business activities in a State. The mismatches with hybrid permanent establishments can be divided into four main types:

a. disregarded permanent establishments;
b. payments to an entity with a permanent establishment;
c. situations involving presumed payments ('dealings');
d. situations involving double deductions.

With regard to situation a., in the case of disregarded permanent establishments, the Netherlands will, as the country of the head office, effectively tax the income in the Netherlands. The Netherlands will also implement the rule that the deduction of the payments will be refused in the case of payments to a disregarded permanent establishment. It can be inferred from the explanatory notes to the bill, that the Netherlands will not levy tax if a tax treaty between the Netherlands and the country of the permanent establishment prescribes that the Netherlands must grant an exemption.

If a Dutch company makes payments to an entity with a permanent establishment (situation b.) and the entity's State and the State of the permanent establishment attribute the payments to one another, then the Netherlands will have as primary rule that the deduction of the payments to the entity will be refused. In addition to this, the

Netherlands will implement as secondary rule that the income will be taxed in the head office's State if the payor's State does not refuse the deduction.

In cases of a presumed payment between head office and permanent establishment that leads to a deduction without the presumed payment being taxed (situation c.), the Netherlands will have as primary rule that the deduction at the permanent establishment will be refused. As secondary rule, the Netherlands will tax the presumed payment at the level of the head office.

In situations where there is double deduction (situation d.), if the Netherlands is the State of the investor, it will effectively refuse the deduction insofar as there is a double deduction. If the Netherlands is the payor's State and the investor's State does not refuse the deduction, then the Netherlands will refuse the deduction insofar as there is a double deduction.

2.4 Mismatch with hybrid transfers

Hybrid transfers are treated as a type of (hybrid) financial instrument. This is often a combination of transactions, for example, the lending of shares around the dividend date. Such a hybrid transfer between parties in various countries and the associated different treatment may result in a deductible item being taken into account at the one contracting party, while no corresponding income is taxed at the other contracting party. In that case the primary rule is that the deduction will be refused in the payor's State. As secondary rule, the income will be taxed in the recipient's State.

2.5 Imported hybrid mismatches

Hybrid mismatches can also occur between two or more States that are not members of the European Union. These states may not have anti-hybrid mismatch rules. By using taxpayers that are not established in the European Union as intermediaries, mismatches could be imported. These are mismatches that without these intermediaries would be neutralized.

An example of this is the situation where a company in country A (non-EU) provides a hybrid loan to a company in country B (non-EU). The payments on this hybrid loan are deductible in country B and not taxed in country A. The company in country B provides a normal loan to a Dutch company. The payments on this loan are, in principle, deductible in the Netherlands. Without additional rules, this arrangement would result in deductible interest in the Netherlands, while in country B only the balance of the interest income and the deductible payments are taxed, and in country A the payments are received exempt from tax. The Netherlands will refuse the interest deduction in this situation. This would also be the case if funds were lent directly from country A.

Moreover, the Netherlands will not recognize imported hybrid mismatches if in country A or country B a hybrid mismatch rule applies that leads to a similar result as the Dutch hybrid mismatch rules.

2.6 Situations involving dual domicile

Sometimes a company may have a double domicile and be taxed in more than one country. This can occur if there are no tax treaties or because these do not offer a satisfactory solution. In that case, it is possible that the income and expenses are taken into account in more than one country. For such situations, it is stipulated that the deduction will be refused in both countries to the extent that net costs (after the deduction of double-taxed income) are deducted twice. The Netherlands will allow the deduction if the other country is an EU Member State and the treaty between both countries designates the Netherlands as the country of residence.

3 Final remarks

Under ATAD2, the provisions must be applied as of January 1, 2020 or January 1, 2022 (for the subject-to-tax measure). In this respect, the bill provides for the Act to first apply to financial years commencing on or after January 1, 2020 or January 1, 2022 (for the subject-to-tax measure).

Despite the fact that this concerns complex tax (implementation) legislation, it is pleasing to see that, compared to the draft bill and also on the basis of the internet consultation, a number of matters have been clarified in the (explanatory notes to) the bill. The documentation obligation is extremely important for the practice. For the rest, it remains important to assess international arrangements and make changes where necessary.

If the remaining parliamentary process gives reason to do so, we will of course inform you of developments. Please feel free to contact your Meijburg advisor if you have any questions or would like to discuss the above matters.

Meijburg & Co
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