taxnotes® international

Volume 115, Number 4 ■ July 22, 2024

Hybrid Financing Arrangements Under the GLOBE Rules

by Michiel Schul and Steffie Klein

Reprinted from *Tax Notes International*, July 22, 2024, p. 421

Hybrid Financing Arrangements Under the GLOBE Rules

by Michiel Schul and Steffie Klein

Michiel Schul

Steffie Klein

Michiel Schul is a tax partner and Steffie Klein is a senior tax associate with Loyens & Loeff in New York and Amsterdam, respectively.

In this article, Schul and Klein describe hybrid financing arrangements and mismatches between tax systems under the global anti-base-erosion model rules and provide illustrations of how these rules function.

In this article, we describe the treatment of certain hybrid financing arrangements (HFAs) under the OECD's global anti-base-erosion (GLOBE) model rules.[1] We consider the consolidated commentary to the GLOBE rules[2] and examples appended to the GLOBE rules[3] as published on the date of this article's writing. We focus on the relevance of these rules to U.S. multinational enterprises in scope of the GLOBE rules with financing arrangements involving their European subsidiaries and illustrate how the rules work with some practical examples. We first describe how hybrid mismatches between the tax systems of countries are dealt with under the EU anti-tax-avoidance directive 2 (ATAD 2).[4] We then discuss how the antiabuse provision in article 3.2.7 of the GLOBE rules seeks to prevent taxpayers from entering into certain HFAs. The final topic of discussion is how certain elements of the administrative guidance issued by the OECD on December 18, 2023,[5] (the 2023 guidance) contains rules to eliminate mismatches as a result of HFAs for purposes of the transitional country-by-country safe harbor.[6]

Hybrid Mismatches — EU ATAD 2 Rules

Before the introduction of the GLOBE rules, hybrid mismatch arrangements existed only because of mismatches in the tax systems of the countries involved. This generally involved differences in the classification of an instrument or an entity in each country — for example, one country treating an instrument as debt under its tax laws and the other treating it as equity under its tax laws. Differences in the classification of an

[1] OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS" (2021).

[2] OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023)" (2024).

[3] OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two) Examples" (2022).

[4] Council Directive (EU) 2017/952 of May 29, 2017, amending Directive (EU) 2016/1164 regarding hybrid mismatches with third countries. Council Directive (EU) 2016/1164 of July 12, 2016 (EU ATAD) already contained rules regarding hybrid mismatches. However, these rules were limited to situations between EU member states. EU ATAD 2, among others, extended the scope to situations with so-called third countries (i.e., non-EU member states). We therefore focus on the effect of EU ATAD 2 on HFAs in this article.

[5] OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), December 2023" (2023). This guidance is included in annex A, paragraph 91-97 of the consolidated commentary.

[6] OECD, "Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two)" (2022), annex A of the consolidated commentary.

entity also arise if one country classifies an entity as tax transparent and another treats it as opaque for tax purposes. We see this often in structures of U.S. MNEs when a check-the-box election[7] is made to treat an EU subsidiary as a disregarded entity (DRE) for U.S. federal income tax purposes, whereas the EU subsidiary is treated as opaque under the tax laws of its country of residence.

The ATAD 2 rules aim to prevent situations resulting from a hybrid mismatch between the tax systems of the countries involved. The ATAD 2 rules target the following situations: (1) double deductions, (2) deductions without a corresponding inclusion of the income at the level of the recipient, and (3) mismatches resulting from a conflict in the characterization of financial instruments, payments, and entities or from the allocation of payments. In this article we focus on deduction/no inclusion (D/NI) situations.

The primary rule in a D/NI situation under ATAD 2 is that the deduction is denied at the level of the payer. When a loan is, for instance, granted by a U.S. entity to its Dutch DRE subsidiary,[8] then the interest deduction at the Dutch subsidiary level will in principle be denied under the primary rule of ATAD 2.[9] When a loan is granted that results in a deduction in a country outside the EU (e.g., in the United States) and there is no corresponding income inclusion under the tax laws of the EU recipient country, then the secondary rules stipulate that the interest income should generally be included at the EU recipient level.

HFAs Under the GLOBE Rules — Article 3.2.7

As described above, the ATAD 2 rules deal with hybrid mismatches between tax systems. Under the GLOBE rules, hybrid mismatches can also exist because of mismatches (1) between the accounting standards applied by each country or (2) because of a mismatch in the treatment for accounting and tax purposes.

Without specific rules, taxpayers could use these HFAs to increase their effective tax rates for GLOBE purposes. The ETR is determined by dividing the adjusted covered taxes[10] (GLOBE tax) by the so-called net GLOBE income[11] (GLOBE income). For example, the ETR could be increased by granting an instrument that is treated as debt for accounting purposes and as equity for tax purposes by the debtor constituent entity[12] that is located in a jurisdiction with an ETR of less than 15 percent (a low-tax entity).[13] The ETR of the low-tax entity would increase as interest expenses on the HFA would be recognized in the financial accounts of the low-tax entity (decrease of GLOBE income) but not in the tax accounts of this entity (no decrease of GLOBE tax).

A simplified example illustrates this in Figure 1.

For illustrative purposes, we have assumed the facts to be as follows:

- ACo and BCo form part of an in-scope group for GLOBE purposes. ACo is located in jurisdiction A, and BCo in jurisdiction B.

[7]IRC section 7701, also known as the check-the-box regulation, allows an eligible entity (i.e., one not automatically classified as a corporation) to elect to be classified as a corporate entity (association) or a flow-through entity (partnership or disregarded entity (DRE)) for U.S. income tax purposes.

[8]In that case, the Dutch entity will — before applying the ATAD 2 rules — claim a deduction for Dutch tax purposes. But there is no corresponding income inclusion in the United States because the Dutch subsidiary is treated as a DRE for U.S. tax purposes.

[9]If the Dutch subsidiary has taxable income in the Netherlands and that income is also considered for U.S. federal income tax purposes (so-called dual-inclusion income), then the (interest) deduction limitation under ATAD 2 only applies to the extent that the amount of the interest expense exceeds the dual-inclusion income.

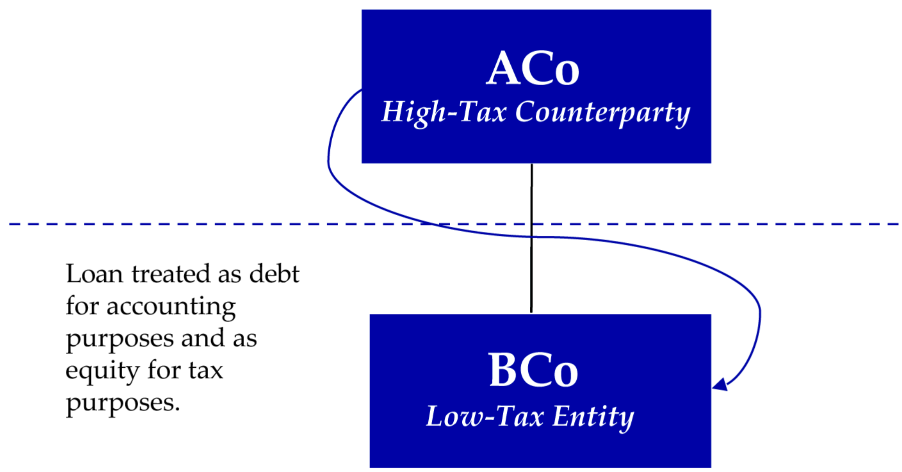
[10]Article 4.1 of the GLOBE rules sets out the definition of adjusted covered taxes. This generally includes income taxes and withholding taxes (allocated to the distributing entity), but it also considers certain deferred tax positions.

[11]Article 3.1 of the GLOBE rules stipulates that the GLOBE income is, as a starting point, based on the income that is reflected in the financial statements. Articles 3.2-3.5 of the GLOBE rules then provide for adjustments to be made to eliminate — amongst others — certain book-tax differences when calculating the GLOBE income.

[12]For GLOBE purposes, a constituent entity is an entity that is included in a group or a permanent establishment of a so-called main entity. An entity is included in the group if it is related through ownership or control so that the assets, liabilities, income, expenses, and cash flows of that entity (i) are included in the consolidated financial statements of the ultimate parent entity of the group or (ii) are excluded from those consolidated financial statements solely on size or materiality grounds or on the grounds that the entity is held for sale. *See* article 1.2.2 and article 1.3.1 of the GLOBE rules.

[13]A low-tax entity is a constituent entity located in a low-tax jurisdiction or a jurisdiction that would be a low-tax jurisdiction if the ETR for the jurisdiction were determined without regard to any income or expense accrued by that entity regarding an intragroup financing arrangement. A low-tax jurisdiction is a jurisdiction where a group in scope of the GLOBE rules has net GLOBE income and is subject to an ETR in that period that is lower than the 15 percent minimum rate. An intragroup financing arrangement is any arrangement entered into between two or more members of an in-scope group in which a high-tax counterparty directly or indirectly provides credit or otherwise makes an investment in a low-tax entity.

Figure 1. Hybrid Financing Arrangement



There are no other group entities in each of these jurisdictions.

- As a starting point, ACo has an ETR of 20 percent as it has GLOBE income of $1,000 and GLOBE tax of $200.
- Without considering the HFA, BCo has an ETR of 10 percent as it has GLOBE income of $200 and GLOBE tax of $20.
- ACo grants an HFA to BCo with an annual interest accrual of $100. The loan is treated as equity for tax purposes and debt for accounting purposes in jurisdictions A and B.

This would result in the following outcome for GLOBE purposes:

- The HFA reduces the GLOBE income of BCo from $200 to $100, while its GLOBE tax remains $20 (no interest deduction for tax purposes).
- Therefore, the ETR of BCo increases from 10 percent to 20 percent (20/100) because of the HFA.
- The GLOBE income of ACo increases to $1,100, and its GLOBE tax remains $200. Its ETR will therefore slightly decrease from 20 percent to 18.18 percent (200/1100). No GLOBE tax would be due in relation to either ACo or BCo as a result because the ETR in both jurisdictions is at least equal to 15 percent.
- This can be summarized as shown in tables 1 and 2.

Table 1. ETR Before ACo Granted HFA to BCo

Entity	GLOBE Income	GLOBE Tax	ETR
ACo	$1,000	$200	20%
BCo	$200	$20	10%

Table 2. ETR *After* Granting the HFA/if Article 3.2.7 GLOBE Rules Does *Not* Apply

Entity	GLOBE Income	GLOBE Tax	ETR
ACo	($1,000 + $100=) $1,100	$200	18.18% **(-1.92%)**
BCo	($200 - $100=) $100	$20	20% **(+10%)**

Article 3.2.7 of the GLOBE rules is an antiabuse provision intended to prevent taxpayers from increasing the ETR of a low-tax entity, like by granting an HFA to that entity without a corresponding increase in the taxable income of a high-tax counterparty.[14] Article 3.2.7

[14]For purposes of the GLOBE rules, a high-tax counterparty is a constituent entity that is located in a jurisdiction that is not a low-tax jurisdiction or would not be a low-tax jurisdiction if its ETR were determined without regard to any income or expense accrued by that entity on an intragroup financing arrangement.

of the GLOBE rules provides that, to compute GLOBE income, (interest) expenses on an HFA are ignored at the borrower level, but the corresponding (interest) income is still included in the GLOBE income of the lender. Article 3.2.7. of the GLOBE rules only applies if the following cumulative criteria are met:

- an intercompany financing arrangement is entered into between a low-tax entity and a high-tax counterparty; and
- it can reasonably be anticipated that over the expected duration of this arrangement:
  - there is an increase of the amount of expenses taken into account in calculating the GLOBE income of the low-tax entity, while simultaneously,
  - there is no commensurate increase in the taxable income of the high-tax Counterparty.

In the example above, the GLOBE position of BCo under the application of article 3.2.7 of the GLOBE rules remains unchanged (i.e., its ETR remains 10 percent) as the interest deduction on the HFA is denied for GLOBE purposes. Despite that, the HFA has a negative effect on the ETR of ACo because it sees an increase in its accounting income but no commensurate increase in its taxable income. This results in a decrease of its ETR from 20 percent to 18.18 percent. This outcome has been summarized in Table 3.

Table 3. ETR After Granting the HFA/if Article 3.2.7 GLOBE Rules Do Apply

Entity	GLOBE Income	GLOBE Tax	ETR
ACo	($1,000 + $100=) $1,100	$200	18.18% **(-1.92%)**
BCo	($200 ~~– **$100**~~) $200	$20	**10%**

The consolidated commentary[15] makes it clear that a payment should not be treated as increasing the taxable income of a high-tax counterparty if it is eligible for an exclusion, exemption, deduction, credit, or other tax benefit under local law *and* the amount of that benefit is calculated by reference to the amount of payment received.

The consolidated commentary further states that one should consider if there is a *corresponding* increase in the taxable income of the high-tax counterparty to the arrangement.[16] In the illustration, this is clearly not the case. However, article 3.2.7 of the GLOBE rules can also come into play in other situations — for example, if there is a regular loan (i.e., qualifying as debt for both accounting and tax purposes) in place between a low-tax entity and a high-tax counterparty whereby the latter uses tax attributes that it would not otherwise have used.[17] The question arises: What happens if the high-tax counterparty uses such a tax attribute (e.g., carryforward interest expenses), but the use of this tax attribute does not fully offset the (interest) income received? This could arise if the use of this tax attribute is limited, for example, because the local tax law prescribes that only a certain percentage or amount of the tax attribute can be used to offset taxable income in a year. In this case, over the expected duration of the intercompany financing arrangement, there would be an increase in taxable income of the high-tax counterparty. However, the increase in (total) taxable income of the high-tax counterparty may not be equal to the (total) decrease in GLOBE income at the low-tax entity level. Therefore, is a partial increase in commensurate income sufficient to avoid applying article 3.2.7 of the GLOBE rules?

Also, it's unclear what would happen if the counterparty to the intercompany financing arrangement is a flow-through entity[18] — and more specifically, a tax-transparent entity.[19] Under the GLOBE rules, a tax-transparent entity is, in

[15] Article 3.2.7, paragraph 127 of the consolidated commentary.

[16] *Id*. In our view, the use of a tax attribute can only fall into scope of article 3.2.7 of the GLOBE rules if the amount of tax attribute used is calculated by reference to the amount of payment received.

[17] *See* Example 3.2.7-2.

[18] An entity is a flow-through entity to the extent that it is fiscally transparent regarding its income, expenditure, profit, or loss in the jurisdiction where it was created unless it is tax resident and subject to a covered tax on its income in another jurisdiction. *See* article 10.2.1 of the GLOBE rules.

[19] A flow-through entity is a tax-transparent entity regarding its income, expenditure, profits, or loss to the extent that it is fiscally transparent in the jurisdiction in which it is located. *See* article 10.2.1(a) of the GLOBE rules.

principle, a stateless entity.[20] As a result, its ETR is generally determined on a stand-alone basis. If such a tax-transparent entity provides a loan to a low-tax entity and the expense is taken into account when calculating the GLOBE income or loss of the low-tax entity, the first question is whether the tax-transparent entity is a high-tax counterparty. Thereafter, it must be determined whether, among other things, there is a commensurate increase in taxable income at the level of this high-tax counterparty.

Under the GLOBE rules, the financial accounting net income or loss (FANIL) of a tax-transparent entity is allocated to its constituent entity-owners according to their ownership interest.[21] For flow-through entities that are fully considered tax-transparent entities, this effectively means that no GLOBE income remains to be allocated to the tax-transparent entity. Then, the tax-transparent entity may by default be a high-tax counterparty because it does not report GLOBE income.[22] However, as a tax-transparent entity, the income that it receives under the loan granted to the low-tax entity will (in principle) never result in an increase of its own taxable income. However, this income may result in an increase of taxable income at the level of the constituent entity-owners of the tax-transparent entity. This should be sufficient to avoid applying article 3.2.7 of the GLOBE rules. This is illustrated in Figure 2.

For illustrative purposes, we assume the facts to be as follows:

- The ultimate parent entity (UPE), GCo, and HCo form part of an in-scope group for GLOBE purposes. GCo is incorporated under the laws of jurisdiction G. HCo is located in jurisdiction H for GLOBE purposes.
- GCo is a fiscally transparent entity regarding its income, expenditure, profit, and loss in jurisdiction G and is therefore not subject to tax in jurisdiction G. GCo is also tax transparent from the perspective of UPE. As a result, GCo qualifies as a tax-transparent entity for GLOBE purposes. It is further assumed that GCo does not apply the income inclusion rule and therefore is a stateless entity.
- GCo provided a loan to HCo. The loan is treated as a loan for both accounting and tax purposes in jurisdictions G and H.
- HCo is a low-tax entity.
- The interest income that GCo derives from the loan provided to HCo, as well as any other FANIL of GCo, is fully allocated to UPE for GLOBE purposes.[23] So no GLOBE income is left behind at the level of GCo. As a result, it may be classified as a high-tax counterparty.
- The interest received is not subject to tax at the GCo level, but it will be taxed at the level of UPE (without being offset by tax attributes that would otherwise not be used).

In our view, this situation should not result in applying article 3.2.7 of the GLOBE rules, provided that the income is subject to tax at the level of UPE. Because the GLOBE rules only provide for the allocation of FANIL (and not the allocation of assets and liabilities) of tax-transparent entities, there is uncertainty.[24]

Transitional CbC Safe Harbor Hybrid Mismatch

The transitional CbC safe harbor temporarily allows an in-scope group to avoid undertaking detailed GLOBE calculations regarding low-risk countries in the initial years by making use of its existing CbC report and financial accounting data

[20] *See* article 10.3.2 and article 10.3.3 of the GLOBE rules. The GLOBE income and GLOBE ETR of a stateless entity is determined without considering the GLOBE income or GLOBE ETR of any other entity. A flow-through entity is not a stateless entity if it is the ultimate parent entity of the in-scope group or is required to apply the income inclusion rule in accordance with article 2.1 of the GLOBE rules. *See* article 10.3.2 of the GLOBE rules.

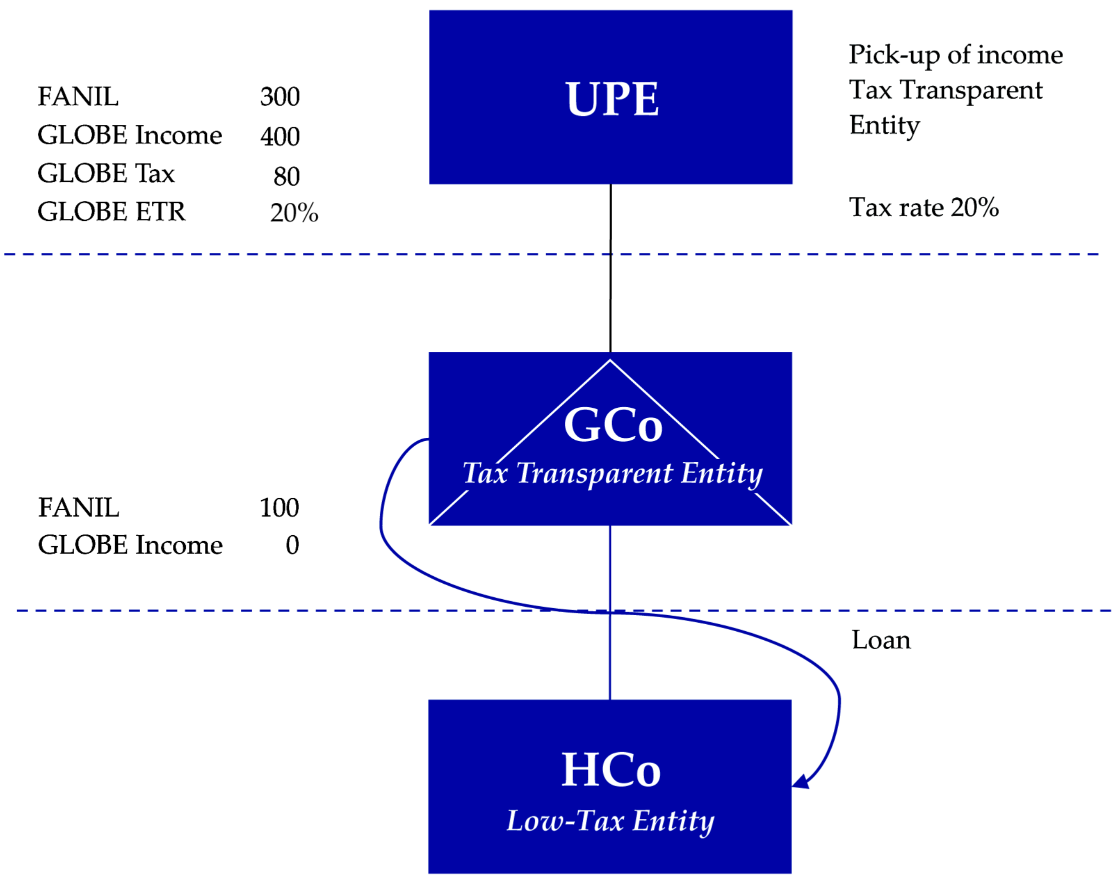
[21] *See* article 3.5.1 of the GLOBE rules (providing that the tax-transparent entity is not the ultimate parent entity of the in-scope group and after considering allocation to a PE under article 3.5.1(a) of the GLOBE rules).

[22] As outlined above, a high-tax counterparty is a constituent entity that is not located in a low-tax jurisdiction, and a low-tax jurisdiction is a jurisdiction where the in-scope group has net GLOBE income and is subject to an ETR that is lower than the minimum rate under the GLOBE rules of 15 percent. In this case, the tax-transparent entity does not report GLOBE income after considering the allocation of FANIL, and therefore it would arguably always be a high-tax counterparty.

[23] Article 3.5.1(b) of the GLOBE rules.

[24] The GLOBE rules also provide for the allocation of taxes between tax-transparent entities and their constituent entity owners in article 4.3.2(b) and provide for rules on the allocation of so-called eligible payroll costs and eligible tangible assets of flow-through entities for the substance-based income exclusion of article 5.3.

Figure 2. Tax Transparent Entity



with little to no modifications. The transitional CbC safe harbor initially did not contain a provision equivalent to article 3.2.7 of the GLOBE rules.

As the OECD became aware that hybrid mismatch structures were implemented by taxpayers during the transitional CbC safe harbor period, it came out with new administrative guidance — the 2023 guidance — relating to so-called hybrid arbitrage arrangements (HAAs). Under this new guidance, a taxpayer must exclude expenses relating to HAAs when assessing its eligibility for the transitional CbC safe harbor if the HAA was entered into after December 15, 2022.[25] That date was chosen because it was the date of the release of the transitional CbC safe harbor guidance. The 2023 guidance refers to three categories of HAAs: (1) D/NI, (2) duplicate loss arrangements, and (3) duplicate tax recognition arrangements. This article only discusses D/NI situations. The 2023 guidance states that further guidance will be provided to address HAAs under the GLOBE rules themselves, but it is unclear when this guidance to the GLOBE rules will be

[25] If a jurisdiction is unable to apply the 2023 guidance by reference to transactions entered into after December 15, 2022, based on constitutional grounds or other superior law, that jurisdiction can adopt the 2023 guidance as relevant to HAAs as of December 18, 2023 — the date the 2023 guidance was published. In practice, however, we see that jurisdictions may also not be able to adopt December 18, 2023, as the date this guidance becomes applicable. This raises several questions, including which date should be used when an in-scope group assesses if its arrangement would fall into scope of the 2023 guidance relevant to HAAs.

published and whether it will have retroactive effect.

Under the 2023 guidance, a D/NI has been defined as an arrangement in which one constituent entity directly or indirectly provides a credit or otherwise makes an investment in another constituent entity that results in an expense or loss in the financial accounts of that constituent entity, to the extent that there is no commensurate increase in:

- the revenue in the financial accounts of the constituent entity counterparty; or
- the taxable income of the constituent entity counterparty over the life of the arrangement.

In either situation, applying the transitional CbC safe harbor is tested without considering the (income tax) expense on the arrangement.

Unlike article 3.2.7 of the GLOBE rules, this D/NI rule is not limited to loans granted between high-tax counterparties and low-tax entities. Further, the 2023 guidance regarding HAAs does not outline that the amount of benefit used must be calculated by reference to the amount received. This can imply that there are more arrangements falling into scope of the 2023 guidance compared with article 3.2.7 of the GLOBE rules — for example, because the benefit used is not calculated by reference to the amount received.

Also, for purposes of the 2023 guidance regarding HAAs, it is unclear what constitutes an arrangement. From the 2023 guidance, it became clear that for purposes of the transitional CbC safe harbor a decision can be made per jurisdiction which accounting standard will be used for preparing the financial statements.[26] This could result in the same expense being considered by two jurisdictions simply because of a difference in accounting standards. Would this be sufficient to constitute an arrangement?

It has been clarified[27] that for this rule, there is no commensurate increase in taxable income under paragraph 74.30, subsection d of the 2023 Guidance if:

> (i) the amount included in taxable income is offset by a tax attribute, such as a loss carryforward or an unused interest carryforward, with respect to which a valuation adjustment or accounting recognition adjustment has been made or would have been made if the adjustment determination were made without regard to the ability of a Constituent Entity to use the tax attribute with respect to any Hybrid Arbitrage Arrangement entered into after 15 December 2022;[28] or
>
> (ii) the payment that gives rise to the expense or loss also gives rise to a taxable deduction or loss of a Constituent Entity that is located in the same jurisdiction as the Constituent Entity counterparty without being included as an expense or loss in determining the profit before tax for that jurisdiction (including as a result of being an expense or loss in the financial statements of a Flow-Through Entity which is owned by a Constituent Entity in the jurisdiction of the Constituent Entity counterparty).

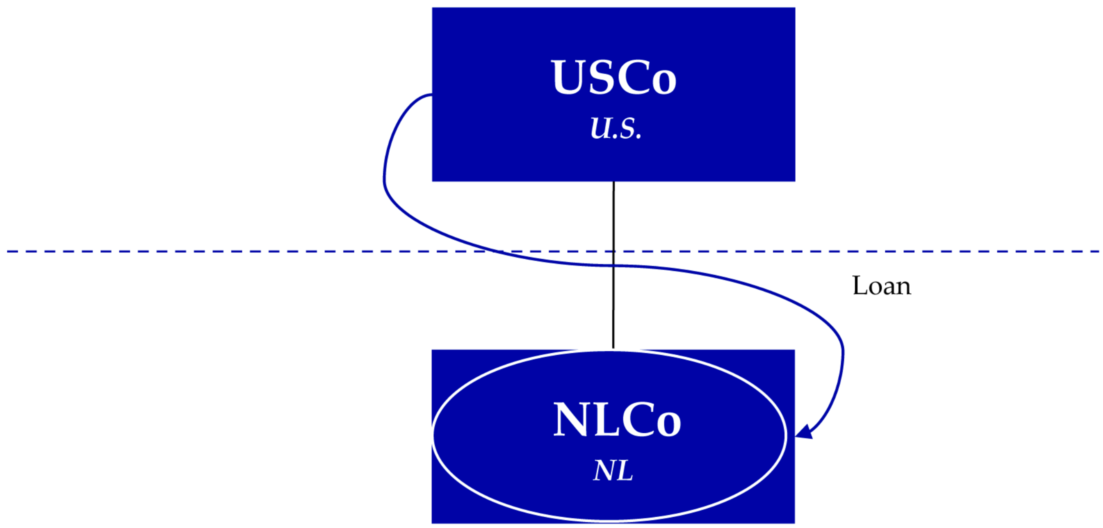
Paragraph (i) could apply when a group financing company benefits from net operating losses that it was not able to recognize for accounting purposes. In that case, the interest income on the group loans is included in taxable income, but no actual (current) tax is due because the income is offset against NOLs. This could result in the denial of the interest expense at the

[26]For example, the financial statements used to prepare the consolidated financial statements or local financial accounts.

[27]The question is, are these the only instances in which there is no commensurate increase in taxable income for purposes of the HAA guidance of the 2023 guidance? Looking at the other definitions included in paragraph 74.30 of the 2023 guidance/Annex A paragraph 96 of the consolidated commentary, this seems to be "in addition to" regular situations that also do not result in a D/NI situation. However, in that case it would have been helpful if the OECD had phrased paragraph 74.30 of the 2023 guidance/Annex A paragraph 96 of the consolidated commentary differently to explicitly address this intention to avoid various implementing jurisdictions taking a different approach.

[28]The question therefore is if you are using a tax attribute that would otherwise have been a "worthless" tax attribute, in which "otherwise" also refers to the situation in which the HAA would not have been in place.

Figure 3. Loan Granted by U.S. Parent to DRE Dutch Subsidiary



level of the borrowing group company for purposes of testing eligibility for the transitional CbC safe harbor. In our view, the outcome would be different if the use of NOLs were limited at the lender group company level, resulting in actual tax due by the lender.

Paragraph (ii) could apply when a U.S. parent entity (USCo 1) holds all shares in a U.S. subsidiary (USCo 2) that in turn holds all shares in an EU subsidiary (EU Sub) that is a DRE for U.S. federal income tax purposes. If USCo 1 grants a loan to EU Sub, then the interest income will be included in the U.S. taxable income of USCo 1, but at the same time USCo 2 may be able to claim a tax-deductible interest expense because of the DRE status of EU Sub. The sanction would be that the interest expense would be denied at the EU Sub level in testing the eligibility for the transitional CbC safe harbor for the jurisdiction in which it is located.

D/NI Situations Under 2023 Guidance

In this section we discuss a couple of practical examples of D/NI situations involving a U.S. parent entity (USCo) with a Dutch subsidiary (NLCo) that is a DRE for U.S. federal income tax purposes.

Example A: Loan Granted by U.S. Parent to DRE Dutch Subsidiary

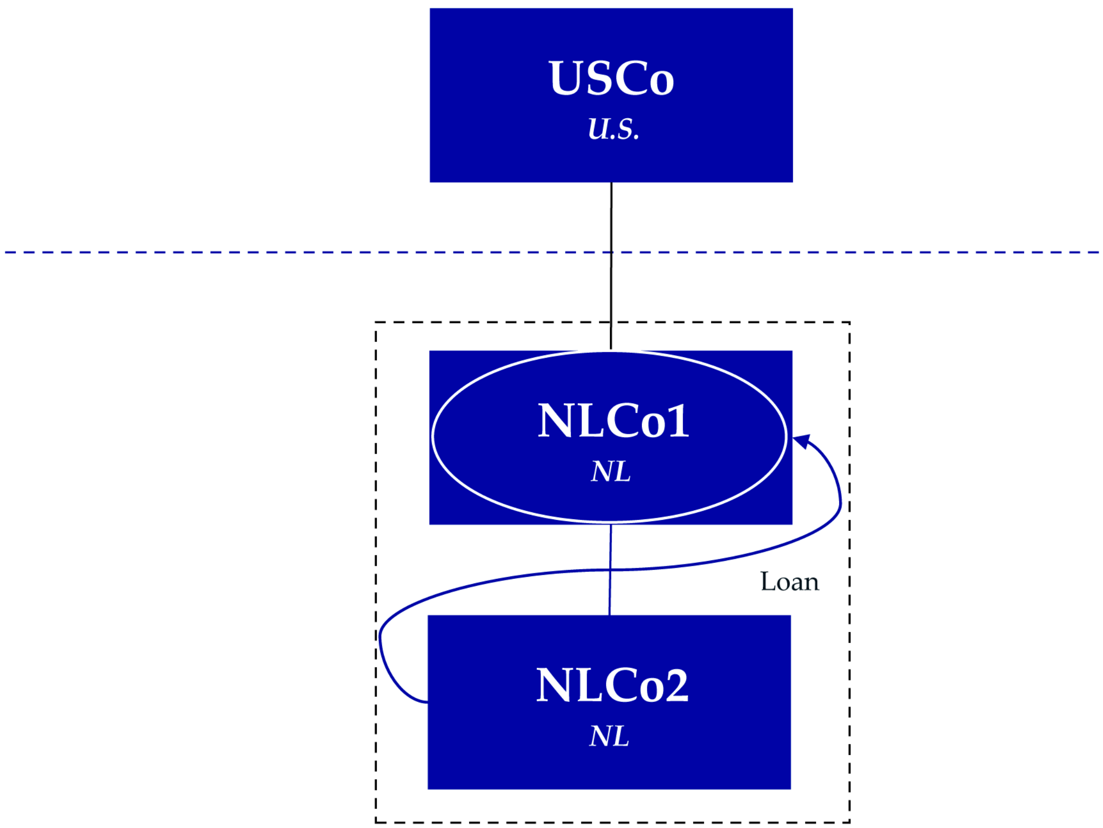
In this first example, a loan is granted by USCo to its DRE subsidiary NLCo.

In this structure there is an expense in the financial accounts of NLCo, but no commensurate increase in the taxable income of USCo because there is no pickup of the interest income for U.S. tax purposes. Therefore, this situation falls within the scope of the 2023 guidance if it was entered into after December 15, 2022.[29] In that case, the expense will be denied at the NLCo level for testing its jurisdiction's eligibility for the transitional CbC safe harbor.

This situation falls within the scope of the ATAD 2 rules because a deduction is claimed for Dutch tax purposes with no corresponding income inclusion for U.S. federal income tax purposes. As a result, the interest on the loan will in principle be denied for Dutch tax purposes under ATAD 2. The fact that the interest is denied for Dutch tax purposes under ATAD 2 does not seem to affect the application of the D/NI rules in the 2023 guidance. This is because after the interest deduction is denied for Dutch tax purposes, there is still a deduction in the financial

[29] Or later. *See infra* note 32.

Figure 4. Loan Granted Within Consolidated Tax Group



accounts of NLCo without a commensurate increase in the taxable income of USCo.[30]

Therefore, the interest expense at the NLCo level will be denied both for Dutch tax purposes under ATAD 2 and for testing the eligibility of the Netherlands to apply the transitional CbC safe harbor. This is illustrated in Figure 3.

Example B: Loan Granted Within Consolidated Tax Group

In this second example, the facts are as follows:

- USCo owns all shares in a Dutch subsidiary (NLCo 1), which in turn holds all shares in another Dutch subsidiary (NLCo 2).
- NLCo 1 is treated as a DRE for U.S. tax purposes, and NLCo 2 as tax opaque.
- NLCo 1 and NLCo 2 form a consolidated tax group (fiscal unity) for Dutch tax purposes, with NLCo 1 as the parent entity.
- NLCo 2 grants a loan to NLCo 1. The loan and the corresponding interest payment from NLCo 1 to NLCo 2 are in principle not recognized for Dutch tax purposes because both entities are included in a tax consolidated group.

Based on the wording of the 2023 guidance, this could qualify as a D/NI situation because there is an expense in the financial accounts of NLCo 1 without a commensurate increase in the taxable income of NLCo 2. The latter is caused by the fact that the interest income is not recognized

[30] Note that the denial of the interest deduction at the NLCo level for tax purposes has a positive effect on the calculation of the ETR for GLOBE rule purposes. The ETR is calculated by dividing the GLOBE tax by the GLOBE income. Because of the denial of the interest deduction in the tax accounts (but not the financial accounts) of NLCo, the interest expense will reduce the GLOBE income of NLCo, whereas the GLOBE tax of NLCo remains the same.

for Dutch tax purposes because the loan is granted within the consolidated tax group between NLCo 1 and NLCo 2.

Simultaneously, there is a D/NI situation within the meaning of ATAD 2. This is caused by a deduction for U.S. tax purposes at the level of USCo because of the DRE status of NLCo 1, but no corresponding income inclusion at the level of NLCo 2 for Dutch tax purposes. Because it concerns a deduction that is claimed outside the EU, the secondary rule — which states that NLCo 1 as parent company of the tax consolidated group should, in principle, include the interest income for Dutch tax purposes — applies.

The question is whether the interest income inclusion at the level of NLCo 1 under ATAD 2 constitutes a commensurate increase in taxable income for transitional CbC safe harbor purposes under the 2023 guidance. Based on the literal wording of the 2023 guidance,[31] this does not seem to be the case because the interest income is taken into account at the NLCo 1 level as parent company of the fiscal unity, whereas the 2023 guidance requires that it results in a commensurate increase in taxable income for NLCo 2 as counterparty. In our view, this would be an undesirable outcome that is also not in line with the rationale behind the rules: to combat D/NI situations.[32] This is illustrated in Figure 4.

Final Remarks

Before the GLOBE rules, hybrid mismatch arrangements existed only because of mismatches in the tax systems of the countries involved. Under the GLOBE rules, hybrid mismatches can now also exist because of mismatches between the accounting standards applied by each country or because of a mismatch in the treatment for accounting and for tax purposes. This adds an additional layer of complexity to the hybrid mismatch rules.

In this article, we discussed how D/NI situations can occur in structures of U.S. MNEs when a check-the-box election is made to treat an EU subsidiary as a DRE for U.S. tax purposes, while that EU subsidiary is treated as opaque under the tax laws of its country of residence. In these situations, U.S. MNEs should beware not only a potential denial of the interest deduction for tax purposes at the EU subsidiary level under ATAD 2 but also a denial of the interest deduction under article 3.2.7 of the GLOBE rules or the effect that this might have for testing eligibility for the transitional CbC safe harbor. ■

[31] Paragraph 74.27.b of the 2023 guidance as included in annex A, paragraph 93.b of the consolidated commentary.

[32] In this case there is an inclusion of the interest income, but because of the mechanics of the fiscal unity regime (in which taxable results are considered at the parent entity level), that income inclusion takes place at the level of another group company in the same country.