Ref. Ares(2015)5580013 - 04/12/2015

ROOM DOCUMENT # 1
Code of Conduct Group (Business Taxation)
8 November 2012
ORIGIN: Commission

WORK PACKAGE 2011 – ANTI-ABUSE: HYBRID ENTITIES & HYBRID PES

MEMBER STATES' RESPONSES & PROPOSED WORKING GROUP

1. INTRODUCTION

In room document #2 of 17 April 2012, the Commission proposed structuring future discussions on mismatches in line with the approach taken by OECD's work in this area. With a view to avoiding duplication of that work, the Commission prepared a summary of the information and examples already gathered by the OECD. The room document also described the relation between the OECD's work and that of the Code Group as well as providing guidance for the Code Group by identifying areas on which the Code Group could concentrate.

During its meeting of 4 June 2012, the Group agreed that further work on mismatches should concentrate on hybrid entities and hybrid PE's using the mutual recognition methodology (i.e. one MS following the tax treatment given by the other). Most MS agreed to proceed along the lines suggested by the Commission in the room document.

Accordingly, room document 3 of 10 September 2012 provided further details concerning the practical implications of that approach, highlighting areas that may require some special attention and included draft texts for guidance notes (see annex 2). Some MS believed that automatically following the classification adopted by another state could have adverse effects in particular circumstances and that the issue required more analysis. As a result the possibility of having detailed technical discussions in a sub-group on the basis of written input by MS was raised, with these discussions beginning under the Irish presidency.

So far 14 responses to the questions included in room document 3 have been received (from, Bulgaria, the Czech Republic, Ireland, Spain, Italy, Lithuania, Malta, Austria, Romania, Slovenia, Slovakia, Finland, Sweden and the UK). These are included in annex 1.

2. MEMBER STATES' RESPONSES

The responses received generally support COM's initiative and recognise that there is a need for technical discussions of the proposals put forward in the draft guidance. They also indicate some of the areas that the Code Group members would need to discuss. These are presented below under

five general headings. They have not been presented in order of importance or materiality and the list should not be seen as final since a number of MS have yet to respond.

a. Scope of the discussions

It would have to be decided in which circumstances the draft guidance would apply. It could, for example, in the case of hybrid entities apply to all such entities or be restricted either to transactions between hybrid connected parties or to transactions involving abuse whether or not the parties were connected.

The question also arises of which abuses the guidance was intended to counter, e.g. double low or non-taxation, double deduction, deduction/no inclusion.

b. Interaction with national legal systems

Some MS raised the question of how the guidance on hybrid PEs interacts with their reliance on the credit method for reducing double taxation, questioning whether the proposed guidance should apply to them.

A number of the responses recognise that if the mutual recognition methodology were adopted its logic would require changes be made in MS' domestic legislation. Some discussion would therefore be needed as to how the proposals could be integrated into MS' legal systems. For example, the mutual recognition approach could result in a tax liability in one MS being determined by a decision of a tax authority in another. If this happened would the appeal procedures in the first MS operate effectively or would a new procedure have to be introduced?

Differing national time limits for submitting and auditing tax returns may also need to be considered as would the potential administrative burden. These issues would be relevant whether or not a particular MS made changes to its domestic recognition rules.

c. Interaction with double taxation agreements

A number of MS mentioned the proposals' interaction with double taxation conventions and the difficulties that might arise where the mutual recognition methodology give rise to a different result to a bilateral agreement regarding, for example, the denial of treaty benefits or the existence of a PE. The potential impact on double taxation agreements would need to be considered.

d. Impact assessment and practical examples

If MS were to change their domestic legislation they would have to have a full understanding of the impact that this would have. The examination of the potential consequences would need to cover the direct impact of mutual recognition (e.g. the greater scope for trafficking losses or other artificial schemes) as well as the behavioural aspects (e.g. inadvertently encouraging the creation of harmful tax regimes).

A sub-group could therefore be used to share MS' experiences and examples of identifying and countering abusive practices. This could include practical issues such as the exchange of information and the value in producing lists of possible legal forms in MS.

e. Application to third countries

There was general agreement that it would be appropriate to adopt a complementary strategy regarding third countries but the difficulties of making this work in practice were clearly a concern for MS. This issue is therefore one that would need to be reconsidered as the proposed technical discussions developed.

3. PROPOSED TECHNICAL DISCUSSIONS

COM's proposal is that technical discussions be undertaken by a sub-group of the Code of Conduct Group with a remit to review the draft guidance on hybrid entities and hybrid PEs in room document 3 (10 September 2012) in order to finalise proposals to counter the associated abusive practices. Taking account of MS' views it would initially focus on the following technical issues:

- the practical effect and impact on MS of the draft guidance;
- the proposals' interaction with double taxation conventions, and;
- complementary strategies to be adopted with respect to third countries.

- **Do Member States agree to technical discussions focussing on these areas being held in a sub-group?**

WORK PACKAGE 2011 – ANTI-ABUSE: HYBRID ENTITIES & HYBRID PES

MEMBER STATES' RESPONSES

Bulgaria

- Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid entities within the EU and involving hybrid entities established in 3rd States?

  Republic of Bulgaria believes that a classification based approach is a solution for removing mismatch situations caused by hybrid entities within the EU and involving hybrid entities established in 3rd States.

- Do MS agree with the text of the above draft guidance proposed to that extent?

  Republic of Bulgaria supports the text of the draft guidance as proposed by the Commission.

- Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid entities between a MS and a 3rd State where the hybrid entity is established under the laws of a MS?

  Bulgaria supports the Commission's view that a complementary strategy is needed regarding mismatch situations with hybrid entities between a MS and a 3rd State.

- Do MS have a preference for one or more of the possible supporting initiatives listed under (1) to (3) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?

  We generally support the Commission's efforts to convince 3rd States to follow the EU approach by promoting it in global fora (OECD). We believe that the combination of the approach based on mutual recognition for intra EU situations with a unilateral recognition approach subject to conditions in mismatch situations with hybrid entities between a MS and a 3rd State is a good solution for avoiding the mismatch situations.

- Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid PEs within the EU and – depending on the type – also involving 3rd States?

  In principle, Bulgaria believes that the classification based approach is a solution for removing mismatch situations caused by hybrid PEs within the EU and 3rd States.

- Do MS agree to the proposal to apply different solutions for the question as to who is the leading State, depending on the type of hybrid PE?

We generally support the proposal to apply different solutions for the question as to who is the leading State, depending on the type of hybrid PE.

- Do MS wish to comment on the text of the above draft guidance proposed to that extent?

  We support the proposed draft guidance.

- Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid PEs involving a 3rd State head office (in case a) type hybrid PEs) or involving a 3rd State PE (in case b) type hybrid PEs)?

  Bulgaria believe that a complementary strategy to address mismatch situations with hybrid PEs involving a 3rd State head office (in case a) type hybrid PEs) or involving a 3rd State PE (in case b) type hybrid PEs) is needed.

- Do MS have a preference for one or more of the possible supporting initiatives listed under (1) and (2) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?

  In terms of international cooperation between MS and third countries, Bulgaria supports the Commission's proposal to combine the approach based on mutual recognition for intra EU situations with a unilateral recognition approach subject to conditions in mismatch situations involving 3rd States.

Czech Republic

With reference to the meeting of the Code of Conduct Group held on 10 September 2012, we are sending the following answers on behalf of the Czech Republic regarding the information on Hybrid Entities and Hybrid PEs (room document 3).

The Czech Republic appreciates the Commission's work on the document and generally agrees that it is necessary to resolve any discrepancies that arise between the Member States or Member State and a 3rd State, in the case of hybrid entities, as well as in the case of hybrid PEs.

This is an important question; it would be appropriate to analyze the issue in more depth first. The Czech Republic believes that the development of guidelines without deeper analysis could lead to some problems.

The Czech Republic agrees with the proposal to create a sub-group that would examine in detail practical impact of individual particular measures.

Ireland

- Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid entities within the EU and involving hybrid entities established in 3rd States?
- Do MS agree with the text of the above draft guidance proposed to that extent?

As the effects of a hybrid entities, which can lead to both "deduction/no inclusion" and to "double deduction", are less uniform than in the case of the hybrid instrument (PPL) examined, a classification-based approach, with general support from Member States, offers the prospect of a comprehensive and relatively straightforward response to mismatches of hybrid entity treatments within the EU. However, extending coverage to mismatches involving 3rd countries would involve a fragmenting of that single approach.

Coordination based on the draft guidance, which would have to be incorporated into domestic law, could be effective as respects mismatches within the EU.

- Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid entities between a MS and a 3rd State where the hybrid entity is established under the laws of a MS?
- Do MS have a preference for one or more of the possible supporting initiatives listed under (1) to (3) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?

Addressing mismatch situations involving 3rd countries would be very challenging.

a. *Securing adoption of an EU approach in global fora would be difficult.*
b. *While there may be merit in some instances in considering effects-based approaches, as illustrated by the Room Document example "MS shall introduce provisions limiting the deduction for expenses in case the same expenses are also deducted from the taxable income by a foreign affiliated company.", this would involve further fragmentation of the approach to mismatches.*
c. *The proposed initiative 3 - whereby the MS treatment of an entity established in that MS would follow the treatment, which may be discretionary or elective, of such an entity in a 3rd State - would create uncertainty in relation to classification in Member States.*

It would be useful to clarify whether the intention in relation to the hybrid entity mismatch proposals would be to address classifications for the purposes of determining the treatment of transactions undertaken between related parties only.

- Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid PEs within the EU and – depending on the type – also involving 3rd States?
- Do MS agree to the proposal to apply different solutions for the question as to who is the leading State, depending on the type of hybrid PE?
- Do MS wish to comment on the text of the above draft guidance proposed to that extent?

The classification-based mutual recognition approaches, with different leading States depending on which of two types of Hybrid PE is involved, offers the prospect of a comprehensive response to mismatch situations caused by hybrid PEs within the EU. Ireland neither exempts branch income nor provides deductions for notional branch expenses.

- Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid PEs involving a 3rd State head office (in case a) type hybrid PEs) or involving a 3rd State PE (in case b) type hybrid PEs)?
- Do MS have a preference for one or more of the possible supporting initiatives listed under (1) and (2) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?

Securing adoption of an EU approach in global fora would be difficult and addressing mismatch situations involving 3rd States is likely to require a unilateral recognition approach.

As the guidance aimed at case a) type hybrid PEs involving a 3rd State head-office does not appear to address the general MS treatment in such circumstances, for the avoidance of doubt it should perhaps begin "Where it would otherwise treat those activities as not constituting a PE . . .".

Spain

Hybrid Entities

Regarding hybrid entities, the guidance proposed by the Commission is acceptable for intra EU situations but we do not think it solves the problem with third States.

In the case of third States involvement, we consider necessary a complementary strategy. One possible solution could be the initiative 2 (to limit the deduction for expenses in case the same expenses are also deducted from the taxable income by a foreign affiliated company).

Hybrid PEs

Regarding hybrid PEs, we do not see that the proposed solutions solve the problem either for intra EU cases or for cases involving a third State. It is important to note that there is an extensive network of Double Tax Conventions which states what is meant by PE and how to attribute the profits. In practice, these solutions proposed in this document could enter in conflict with the provisions of the Conventions, and therefore with the domestic legislation in each State.

[redacted]

Lithuania

Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid entities within the EU and involving hybrid entities established in 3rd States?

Do MS agree with the text of the above draft guidance proposed to that extent?

Lithuania is of the view that proposed solution (classification based approach) could be discussed as possible measure to solve the problem of double non-taxation of hybrid entities. However to Lithuania's point of view the text of draft guidance obliging the State in which partners are residents to recognize status of the entity awarded by the State of registration of that entity is rather too strict: guidance could just emphasize that the same treatment to the entities as awarded by the State of registration would provide possible solution to the problem of double non-taxation or recommend to follow such treatment. Furthermore, Lithuania does not have rules and criteria for classification of entity as being transparent therefore it is not clear enough how such aforementioned solution could be reflected in national tax laws in order to tax profits at partners' level.

Moreover it should be noted that in any case aforementioned mechanism will function effectively only if possibility to get information on status of entity awarded by the State of registration (maybe it could be the list of possible legal forms of entities in Member States) and on income of transparent entities will be assured.

Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid entities between a MS and a 3rd State where the hybrid entity is established under the laws of a MS?

Do MS have a preference for one or more of the possible supporting initiatives listed under (1) to (3) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?

Lithuania is of the view that initiatives (1) and (2) could be discussed. However, as regards initiative (2), related to safeguard from harmful effects of mismatch situations with hybrid entities, it should be analyzed more properly and in any case it would be more acceptable if it was stated as recommendation rather than an obligation for Member State.

Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid PEs within the EU and – depending on the type – also involving 3rd States?

Do MS agree to the proposal to apply different solutions for the question as to who is the leading State, depending on the type of hybrid PE?

Do MS wish to comment on the text of the above draft guidance proposed to that extent?

Lithuania always followed the view that methods of elimination of double taxation should be applied only in situations where double taxation arises de facto. Therefore according to Lithuanian national tax laws while applying the exemption method for profit attributed to PE and seeking not to create possibilities for double non-taxation the factual taxation of this profit should be assessed.

As regards recommendations for calculating the profit attributable to a PE at the moment it is hard to evaluate whether the proposed solution would not cause too big administrative burden comparing to extent of the problem itself.

Furthermore, we would like to stress once more that proposed solutions in the recommendations should not be stated as obligations for Member States.

Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid PEs involving a 3rd State head office (in case a) type hybrid PEs) or involving a 3rd State PE (in case b) type hybrid PEs)?

Do MS have a preference for one or more of the possible supporting initiatives listed under (1) and (2) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?

Lithuania would be of the view that only initiative (1) could be discussed as possible measure to solve problem of double non-taxation in mismatch situations with hybrid PEs.

[redacted]

Austria

Austria welcomes the work of the Commission on Hybrid Entities and Hybrid PEs which is a good starting point for further discussion.

Without any doubt action should be taken against tax planning schemes based on check the box rules and similar provisions in EU Member States and in third countries which result in double non-taxation or low taxation. But before the Group agrees on guidance notes in order to curb these schemes we think that an in depth analysis will be necessary.

Romania

- Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid entities within the EU and involving hybrid entities established in 3rd States?
- Do MS agree with the text of the above draft guidance proposed to that extent?

Romania doesn't have specific provisions for hybrid entities and supports the working procedure proposed by the Commission to analyze mismatch situations caused by hybrid entities/ hybrid permanent establishments and the guidance's draft proposed to that extent.

- Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid entities between a MS and a 3rd State where the hybrid entity is established under the laws of a MS?
- Do MS have a preference for one or more of the possible supporting initiatives listed under (1) to (3) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?

Romania sustains the working procedure proposed by the Commission and appreciates the concern for specific solutions.

- Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid PEs within the EU and – depending on the type – also involving 3rd States?
- Do MS agree to the proposal to apply different solutions for the question as to who is the leading State, depending on the type of hybrid PE?
- Do MS wish to comment on the text of the above draft guidance proposed to that extent?
- Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid PEs involving a 3rd State head office (in case a) type hybrid PEs) or involving a 3rd State PE (in case b) type hybrid PEs)?
- Do MS have a preference for one or more of the possible supporting initiatives listed under (1) and (2) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?

Romania agrees to continue further work on this topic and to find detailed and comprehensive solutions for removing mismatches situations for each specific case.

Slovenia

With reference to the Code of Conduct Group work and the request received on September 14, 2012 we provide general comment to the questions in Room document no. 3 preparted for the Code of Conduct Group meeting on September 10, 2012:

We thank the Commission for the work done up to now. We believe that further work is needed regarding the proposed guidance for hybrid entities and hybrid PE's and we are of the opinion that it would be more effective to have this (technical) discussion outside the Code of Conduct Group.

Considering open questions (see below) and different positions of the Group members it seems that it would be best if we would focus (first) on hybrid entities and (second) on hybrid PE's treatment between EU MS.

Some questions regarding the draft guidance for hybrid entities on page no. 2:

- will proposed guidance apply only in situations that would otherwise result in 'harmful effects' (double non-taxation),
- many EU MS including Slovenia will most likely have to change their tax legislation and it seems that it would be rather difficult for countries that do not have transparent entities and that treat all entities (also foreign) as 'opaque' to justify these changes in connection with 3rd States/countries (some of them are on 'black lists' etc.),
- how to implement/enforce the guidance in a way that would be most effective and would not put an additional administrative burden on taxpayers and tax administrations (for example: it would be useful for taxpayers and for tax administrations of EU MS to have an unified list of all transparent entities in different MS).

Regarding the draft guidance for case a) type hybrid PE's – it is not clear if the MS in question (MS with PE in another MS) can meet the draft guidance (or if the draft guidance is even relevant for that MS) if it consistently applies the credit system for avoidance of double taxation for income attributable to PE in another MS.

Regarding the draft guidance for case b) type hybrid PE's – it is not clear if the MS in question (MS in which the PE of a company resident in another MS) can meet the draft guidance (or if the draft guidance is even relevant for that MS) if another MS apply credit system for avoidance of double taxation for income attributable to PE.

Slovak Republic

The Slovak Republic welcomes the work of the European Commission concerning the hybrid mismatch arrangements. This is a complex issue and it is therefore necessary to deal with practical implications of proposed guidance, since we suppose that its potential acceptance would have a direct impact on national tax legislation.

As regards the aforementioned guidance, it would be desirable to clearly clarify the status of it (i.e. to what extent it would be binding for EU Member States) and also the relationship between guidance and double tax treaties.

Finland

- Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid entities within the EU and involving hybrid entities established in 3rd States?
- Do MS agree with the text of the above draft guidance proposed to that extent?

  At this stage, in our view, the matter would require more analysis in regard to the interaction of this approach with the national legal systems as well as the legal instrument required for such an approach. Questions relating to the division of powers to tax and legal certainty closely linked to it, cannot also in our view, be disregarded. In some cases the national legal systems may set some limitations for introducing proposed kind of solutions for mismatch situation, in which the outcome of a tax assessment would be dependent on the decision of tax authorities of another Member State; e.g. the Constitution of Finland requires that taxes are to be regulated by law, established interpretation of which being that a tax law needs to fulfil certain criteria of preciseness and clarity and allow for sufficient legal remedies. Also the aspect of equal treatment in respect of the proposed guidance would, in our view, require further analysis.

- Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid entities between a MS and a 3rd State where the hybrid entity is established under the laws of a MS?
- Do MS have a preference for one or more of the possible supporting initiatives listed under (1) to (3) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?

  First, in regard to the initiatives proposed in the Chapter 3.2 we are not certain if we have understood the text of the proposed guidance under initiative 2 correctly. In this respect, we would appreciate an example, as it could be useful to illustrate the meaning of the aforementioned text. As for the 3. initiative, where an unilateral recognition approach is being proposed with different approaches to MS-MS and MS-3rd country relations, our initial reaction is that this approach might be rather complicated to apply in practice. There might also be differences between Member States and the 3rd countries which the proposed guidance would need to take into consideration. Work has been carried out by the OECD for the purpose of solving these kinds of situation. At this stage, it is not quite clear to us what is the relationship between these discussion to the work carried out by the OECD.

<u>Hybrid PEs – proposed guidance: general notes</u>

As a general comment we would like to note that, in our view, it is ordinarily rare that the MS 1 would consider that an activity of a company resident in MS1 constitutes a PE in MS2. This would be feasible in cases where the PE has generated losses. The case A is based on the starting point

that the MS 1 applies the exemption method. In Finland, however, the main method applied is the credit method.

- Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid PEs within the EU and – depending on the type – also involving 3rd States?
- Do MS agree to the proposal to apply different solutions for the question as to who is the leading State, depending on the type of hybrid PE?
- Do MS wish to comment on the text of the above draft guidance proposed to that extent?

  In order to be able to make any final comments we feel that the substance of the matter would require some additional analysis, e.g. in relation to double tax conventions.

  The text for the draft guidance for case a) type of hybrid PEs, proposes that "MS shall not provide for an exemption for the avoidance of double taxation for income attributable to a PE in another State, be it under domestic law or under an applicable DTC, if such a PE is not recognised as such according to the tax provisions of that other State". We understand the draft guidance text proposes that there is no PE in the source state whereby there cannot be double taxation, due which the resident state cannot by definition provide an exemption. Therefore, we feel that the proposed text does not quite attain the aimed message and that is why we feel that some reformulation might benefit the text of the proposed guidance.

  We understand that the draft guidance for case b) type hybrid PEs would entail that the resident state would categorically waive the right to tax, which, in our view, might be problematic with the mutual agreement procedures laid down in DTCs. Furthermore, in relation to 3rd country relations, we fell the proposed guidance would need further analysis in regard to the DTCs.

- Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid PEs involving a 3rd State head office (in case a) type hybrid PEs) or involving a 3rd State PE (in case b) type hybrid PEs)?
- Do MS have a preference for one or more of the possible supporting initiatives listed under (1) and (2) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?

  In order to be able to make any final comments we feel that the impacts and the background of the matter would require some additional analysis. As stated in the text, not all 3rd States would apply the same mutual recognition approach as agreed within the EU.

[redacted]

United Kingdom

The UK strongly supports the work of the Code Group in examining the problem of mismatches. But given this is a complex area, we would like to see further detailed preparatory work and analysis undertaken before we get to the stage of considering and agreeing guidance. The outcome of any guidance is likely to mean that Member States need to adjust their domestic legislation and in order to do this they will need to have a full understanding of the impact of any changes and will also need to take into account the views of business and other interested parties – this would certainly be the case in the UK with our new approach set out by our Tax Consultation Framework.

At the September meeting, along with other Member States, the UK called for a sub-group to be set up with the remit to examine the issues in detail and to report back to the full group as quickly as possible. The work of the sub-group would provide Member States with the opportunity to share experiences of abusive practices and their current responses which should help identify the most productive approaches. We still see the establishment of a sub-group as the most practical and desirable way forward.

However, for completeness we have set out some initial comments below on the proposals and questions contained in the September room document.

Hybrid entities – intra-EU

As we have stated previously, we have practical concerns about whether a classification-based approach structured around mutual recognition is the right one. At the very least we think further work is needed to work through the consequences, for tax authorities and businesses, of applying this approach across the board. There will be a range of complex interactions to work though involving Member States statute and case law in order to understand the impacts.

There could also be complications in terms compatibility and consistency with Double Tax Agreements where a hybrid entity may be explicitly denied treaty benefits under an existing treaty (or vice versa) and where the proposals for mutual recognition would require a different treatment, and hence there may be a need for DTAs to be renegotiated by Member States.

So at this stage we think it is too early to consider the wording of guidance in detail before we have looked fully at the fundamental issue of whether such an approach is viable for application across all Member States.

Hybrid entities – third country involvement

Adopting the classification based approach would probably suggest that a complementary strategy is needed with regard to third countries. But naturally we will need to make further progress on the substantive options before considering this issue in detail. We will also want to ensure that we stay aligned with any continuing work through the OECD.

Hybrid PEs – intra-EU

In both the scenarios outlined by the Commission, the issue seems to revolve around MS2 departing from international norms and it would seem appropriate for the solution to focus on that rather than require MS1 to recognise MS2's approach.

And as before, mutual recognition in this area would present practical and political difficulties that would have to be taken into account. The UK approach to hybrid permanent establishments is to establish, by way of a main purpose test, whether there is a UK tax advantage created by the use of a hybrid; and if so, then to negate this advantage. Adopting a classification-based approach would require domestic legislative change, and we would need to carefully consider the implications and potential problems that would be created in the operation of UK rules if we were to take this approach.

Hybrid PEs – third country involvement

The UK's concerns on the practicality and effectiveness of the intra-EU approach apply also to the complementary strategy.

In summary, we're keen to work on these issues constructively, using a working method that enables the Group to make the most well-informed and prepared decisions, while identifying the specific areas where we can realistically achieve most progress.

ROOM DOCUMENT 3
Code of Conduct Group (Business Taxation)
10 September 2012
ORIGIN: Commission

WORK PACKAGE 2011 – ANTI-ABUSE

HYBRID ENTITIES & HYBRID PES

1. INTRODUCTION

In Roomdoc #2 of 17 April 2012, the Commission had proposed structuring future discussions on mismatches in line with the approach taken by OECD's work in this area. With a view to avoiding duplication of work undertaken already by the OECD, the Commission prepared a summary of the information and examples already gathered by the OECD in Annex 1 to Roomdoc #2 of 4 June 2012. The Roomdoc itself described the relation between the work undertaken by the OECD and that of the Code Group and provided guidance for the Code Group's further work by identifying areas on which the Code Group could concentrate.

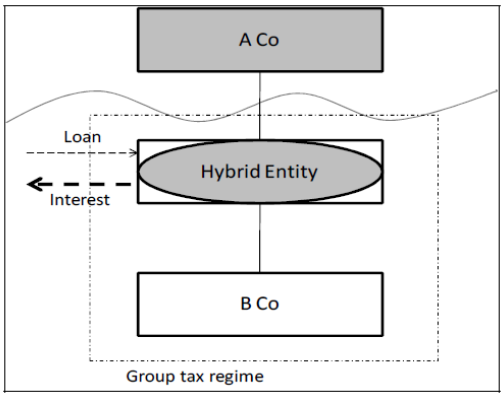
During its meeting of 4 June 2012, the Group agreed that further work on mismatches should concentrate on hybrid entities and hybrid PE's using the mutual recognition methodology (one MS following the tax treatment given by the other). Most MS agreed to proceed along the lines suggested by the Commission in the Roomdoc.

Accordingly, this document provides further details concerning the practical implications of that approach, highlights areas that may require some special attention and introduces first draft texts for guidance notes.

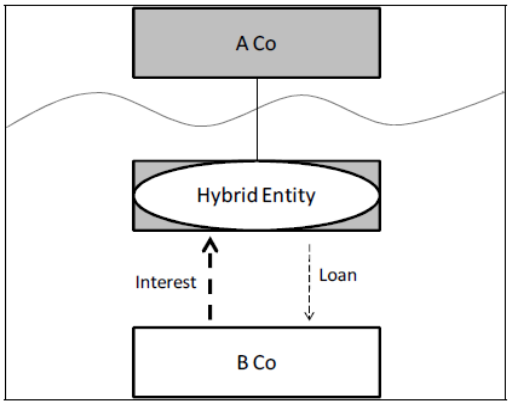
2. GENERAL APPROACH

The various examples gathered by the OECD summarised in Annex 1 to Roomdoc #2 of 4 June 2012 showed that hybrid entities and hybrid PEs can lead either to a "double deduction" effect or to a "deduction/no inclusion" effect.

Scheme 1: "Double Deduction" effect



Scheme 2: "Deduction/no inclusion" effect



In view of the different effects that these mismatch schemes can have, a unique solution based on the effects as provided for the PPL (hybrid instruments) did not seem appropriate. At the meeting on 4 June 2012, the Group therefore agreed on a preference for a "classification based" approach over an "effects based" approach for hybrid entities and hybrid PEs. Furthermore, as a starting point it was suggested that:

1. For hybrid entities, the classification given by the MS under which laws the hybrid entity has been established should be the leading one, with the other MS following the qualification of the leading State, and
2. For hybrid PEs, the position taken by a MS concerning the absence/presence of a PE in its territory or concerning a limited profit allocation to such PE should be followed by the head office (residence) State.

The main benefit of a classification based approach for hybrid entities and hybrid PE's is that it will completely eliminate the mismatch, when applied consistently. This means that separate countermeasures to address all harmful effects of the mismatch will in principle not be needed. The proposed guidance and some practical consequences will be discussed separately for hybrid entities (par. 3) and for hybrid PEs (par. 4).

3. HYBRID ENTITIES – PROPOSED GUIDANCE

3.1 Intra EU situations

The guidance suggested below will remove all mismatch situations involving hybrid entities within the EU, when applied consistently by all MS, as well as some situations involving 3rd States.

Draft guidance for hybrid entities

A hybrid entity is an entity that is treated as transparent for tax purposes under the national classification rules of one State and as non-transparent (opaque) under the national classification rules of another State.

With a view to avoiding the harmful effects of mismatch situations caused by hybrid entities, a Member State shall apply the same treatment as transparent or non-transparent to hybrid

entities established under the laws of another State as the treatment given by that other State, regardless of its national classification rules.

When applied consistently, this will not only eliminate mismatch situations with hybrid entities in the EU, but also situations between a MS and a 3rd State where the hybrid entity is established under the laws of that 3rd State (e.g. US limited partnerships or LLC's). In those situations, all MS would apply the same treatment to these entities as awarded by the US authorities.

- **Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid entities within the EU and involving hybrid entities established in 3rd States?**
- **Do MS agree with the text of the above draft guidance proposed to that extent?**

3.2 Complementary strategy in case of 3rd State involvement

As was mentioned during the 4 June 2012 Code meeting, the full benefits of mutual recognition in a classification based approach would be achieved on a worldwide basis with all States participating. As this will initially not be the case[1], mismatch situations with hybrid entities between a MS and a 3rd State where the hybrid entity is established under the laws of a MS, will require a complementary parallel strategy. Accepting that as a first step the beneficial effects of the proposed guidance will apply to intra EU situations and to situations where the hybrid entity is established under the laws of a 3rd State, the Group could combine the preferred classification based approach with one or more of the following supporting initiatives:

(1). Promote the EU approach in global fora (OECD) with a view to convincing 3rd States to follow the EU approach;

(2). Combine the classification based guidance with specific measures to be implemented by MS to target the harmful effects of mismatch situations with hybrid entities between a MS and a 3rd State where the hybrid entity is established under the laws of a MS. In developing guidance to that effect the Group could build on experience gained by some MS with such specific measures. An example could be:

MS shall introduce provisions limiting the deduction for expenses in case the same expenses are also deducted from the taxable income by a foreign affiliated company.

[1] For a hybrid entity established under the laws of a MS, the US at this stage will not recognise the qualification awarded by that MS. The US is frequently used in such hybrid schemes as a result of the flexible US check-the-box rules that allow taxpayers to choose the qualification of foreign subsidiaries as either transparent or non-transparent. If for example in the scheme 1 above A Co is a US entity and hybrid entity is a French Sarl, Dutch BV or a German GmbH, the preferred approach will not remove the mismatch effect.

(3). Combine the approach based on mutual recognition for intra EU situations with a unilateral recognition approach subject to conditions in mismatch situations with hybrid entities between a MS and a 3rd State where the hybrid entity is established under the laws of a MS. This would ensure that mismatch situations are also removed in cases where a 3rd State would be expected to follow a MS classification under the EU guidance, but does not (yet) do so.

Aimed at hybrid structures with a 3rd State parent company:

If an entity established under the laws of a MS is treated as transparent under the laws of a 3rd State in which the shareholders/partners of that entity are resident, it shall also be treated as such in that MS regardless of the national classification rules of that MS.

Aimed at reverse hybrid structures with a 3rd State parent company:

If an entity established under the laws of a MS is treated as an entity under the laws of a 3rd State in which the shareholders/partners of that entity are resident, it shall also be treated as such in that MS regardless of the national classification rules of that MS.

- **Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid entities between a MS and a 3rd State where the hybrid entity is established under the laws of a MS?**
- **Do MS have a preference for one or more of the possible supporting initiatives listed under (1) to (3) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?**

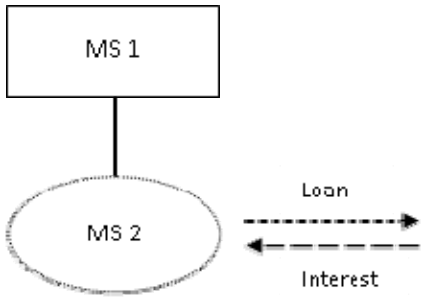
4. HYBRID PES – PROPOSED GUIDANCE

4.1 Introduction

As a reminder, the term "hybrid PE" has been introduced to describe situations in which:

a) a company resident in MS 1 is active in MS 2, whereby MS 1 considers the activity to constitute a PE and MS 2 does not; or
b) A company resident in MS 1 has a PE in MS 2, but the profit allocated to the PE under MS 1 tax provisions is not the same as the profit allocated to the PE under MS 2 tax provisions.

As with other mismatch arrangements, both cases can lead to either double taxation or to double non-taxation. For the purpose of this document, we focus on double non-taxation.



Example case a):

A fully equity financed company in MS1 grants intra-group loans or licenses via its branch office in MS 2. MS 1 considers the intra-group financing/licensing activities to constitute a PE in MS 2, allocates the intra-group financing profits to that PE and provides an exemption for these profits (either under domestic law or under the DTC applicable between MS 1 and MS 2). MS 2, however, does not regard intra-group financing/licensing activities as a trade or business and therefore considers that there is no taxable presence (PE) of MS 1 in its State. As a consequence, the intra-group financing/licensing income will not be taxed anywhere.

Example Case b):

A fully equity financed company in MS1 grants intra-group loans or licenses via its branch office in MS 2. Both MS now conclude that the activities constitute a PE in MS 2. However, in determining the profit attributable to the PE, MS 2 applying standards used in financial regulations taxes the PE as if it were for only a small portion equity financed (app. 10%) and for the majority debt financed (app. 90%). As a consequence, MS 2 allows the deduction of notional interest expenses leading to a significant reduction of the PE's taxable income in MS 2. MS 1 considers that all the intragroup income is attributable to the PE and exempts all or most of the PE profits. Again, as a consequence a significant part of the intra-group financing/licensing income will not be taxed anywhere[2].

As can be seen from the above examples, the typical effect achieved by such hybrid-PE schemes is the "deduction/no-inclusion-effect". The interest/royalties paid by group companies will be deducted at that level whereas they are not or only limitedly taxed in the hybrid PE scheme. In theory one could also envisage a "double-deduction effect", but that seems at this stage rather theoretical as in practice such schemes will be set up using hybrid entities.

4.2. Intra EU situations

[2] In our dialogue with CH, we have noted that CH is an example of a third state that allows the notional deduction of interest for a finance branch, but it seems this is also possible in some purely internal EU relations.

In order to avoid the mismatch in the above cases (both a and b), again one could apply the mutual recognition approach. Unlike for hybrid entities, however, it is not entirely clear who should be the leading party in these arrangements from the outset. Two solutions could be envisaged:

1) If the head office State (MS 1) was to follow the PE State (MS 2), the head office State should not provide for an exemption for the avoidance of double taxation (in case a) or it should provide for a limited foreign profit exemption reducing the foreign PE income with notional interest expenses (in case b).

2) If the PE State (MS 2) was to follow the head office State (MS 1), the PE State effectively would be forced to either recognise the PE and tax its income where it would normally not do so (in case a), or it would need to refrain from allowing a notional deduction of deemed interest expenses (in case b).

In COM's view, cases a) and b) above could each call for a different solution. The first solution (head office State follows PE State) seems most appropriate for case a) type hybrid PEs, whereas the second solution (PE State follows head office State) seems more appropriate for case b) type hybrid PEs. This would materialise in the following draft guidance notes.

Draft guidance for case a) type hybrid PEs

MS shall not provide for an exemption for the avoidance of double taxation for income attributable to a PE in another State, be it under domestic law or under an applicable DTC, if such a PE is not recognised as such according to the tax provisions of that other State.

Since the reason for exempting the PE income is the avoidance of double taxation, the presence of double taxation is a logic condition for granting double tax relief. Since it is usually the taxpayer in MS 1 that claims the exemption of some income components given the presence of a PE in MS 2, applying this guidance in practice should not be too problematic. MS 1 only needs to introduce a provision that a taxpayer making such a claim substantiates this by proving that the tax administration of MS 2 takes the same position. If the taxpayer cannot deliver such evidence, MS 1 should not grant any exemption "for the avoidance of double taxation".

Draft guidance for case b) type hybrid PEs

In calculating the profit attributable to a PE in its MS of a company resident in another State, MS shall only allow the deduction of notional expenses if the tax payer provides evidence that the notional expense is also taken into account by the tax administration of MS 1 when calculating the profit attributable to that PE, thereby reducing the exemption for the avoidance of double taxation.

In case b), it seems more logical for MS 2 to adapt to MS 1. In that situation it is MS 2 who takes a position that is potentially beneficial for the taxpayer and that may be theoretically defendable but is also rather unusual in an international context.

When applied consistently, this will not only eliminate mismatch situations with hybrid PEs in the EU, but also situations between a MS and a 3rd State where the head office is in a MS and the PE is in a 3rd State (in case a) type hybrid PEs), or where the PE is in a MS and the head office is in a 3rd State (in case b) type hybrid PEs).

- **Do MS agree that a classification based approach provides the best solution for removing mismatch situations caused by hybrid PEs within the EU and – depending on the type – also involving 3rd States?**
- **Do MS agree to the proposal to apply different solutions for the question as to who is the leading State, depending on the type of hybrid PE?**
- **Do MS wish to comment on the text of the above draft guidance proposed to that extent?**

4.3 Complementary strategy in case of 3rd State involvement

As with hybrid entities, mismatch situations with hybrid PEs whereby either the head-office (for case a) type hybrid PEs) or the PE (for case b) type hybrid PEs) is located in a 3rd State, will require a complementary parallel strategy. Not all 3rd States will apply the same mutual recognition approach as agreed within the EU[3]. Similar to the strategy suggested for hybrid entities, the Code Group could combine the guidance proposed in par. 4.2 above with one or more of the following supporting initiatives:

(1). Promote the EU guidance on mutual recognition for hybrid PEs in global fora (OECD) with a view to convincing 3rd States to go along with the EU approach;

(2). Combine the approach based on mutual recognition for intra EU situations with a unilateral recognition approach subject to conditions in mismatch situations involving 3rd States. This would ensure that mismatch situations are also removed in cases where a 3rd State would be expected to follow a MS classification under the EU guidance, but does not do so.

> Aimed at case a) type hybrid PEs involving a 3rd State head-office:
>
> *MS shall consider the activities in its State of a company resident in a 3rd State to constitute a PE and tax the profit attributable to this PE in line with its domestic tax provisions, if the 3rd State grants an exemption for the avoidance of double taxation for the income attributable to that PE.*
>
> Aimed at case b) type hybrid PEs involving a 3rd State PE:

[3] As mentioned in footnote 2, CH is an example of a third state that allows the notional deduction of interest for a finance branch. If the head-office was located in a MS, under the mutual recognition approach proposed in par. 4.2 it would be for CH to adapt to the treatment in the MS concerned.

If a 3rd State in calculating the profits attributable to a PE of a company resident in a MS allows the deduction of notional expenses, that MS shall also take into account such notional expenses when calculating the profit attributable to that PE, thereby reducing the exemption for the avoidance of double taxation.

- **Do MS agree to the need for a complementary strategy to address mismatch situations with hybrid PEs involving a 3rd State head office (in case a) type hybrid PEs) or involving a 3rd State PE (in case b) type hybrid PEs)?**
- **Do MS have a preference for one or more of the possible supporting initiatives listed under (1) and (2) above? Do MS wish to comment on either of these possibilities or do MS prefer alternative supporting initiatives?**
