CONFEDERATION FISCALE EUROPEENNE

Opinion Statement FC 9/2014 of the CFE on the two OECD Discussion Drafts: Neutralise the effects of hybrid mismatch arrangements (BEPS Action 2)

Prepared by the CFE Fiscal Committee

Submitted to the OECD

in May 2014

CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 32 professional organisations from 25 European countries (21 EU member states) with 180,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe.
CFE is registered in the EU Transparency Register (no. 3543183647-05).

We will be pleased to answer any questions you may have concerning CFE's comments outlined below. For further information, please contact Mr. Piergiorgio Valente, Chairman of the CFE Fiscal Committee or Rudolf Reibel, Fiscal and Professional Affairs Officer of the CFE, at brusselsoffice@cfe-eutax.org.

Sincerely yours,
Confédération Fiscale Européenne

On 19 March 2014, the OECD released two Discussion Drafts on neutralising the effect of hybrid mismatch arrangements for public comment, titled (1) Recommendations for Domestic Laws[1], and (2) Treaty Aspects of the Work on Action 2 of the BEPS Action Plan[2].

General comments:

The two Discussion Drafts showed two possible approaches to addressing hybrid mismatches: Under a top down approach the rules would apply to all transactions involving hybrid instruments with certain limited exceptions. Under a bottom-up approach the rules would apply to instruments held between related parties and instruments entered into as part of a tax-motivated "structured" arrangement. We understand from a recent statement of Pascal Saint-Amans[3] that the OECD favours the bottom-up approach. We welcome this more targeted approach.

In our view, the ideal solution would be common, internationally agreed concepts of debt and equity.

The current suggested measures are complex and would be difficult to implement. For example there are different rules which apply to related- and unrelated party transactions. Apart from an increase in compliance costs, we are particularly worried about the creation of new potential situations of double taxation. To reach a solution, the OECD should work towards mandatory binding arbitration and more effective MAPs.

EU Treaty freedoms:

As the majority of OECD and G20 countries are EU member states, bound by the fundamental freedoms in the Treaty on the Functioning of the EU, notably the free movement of capital (Art.63 TFEU), and their interpretation by the EU Court of Justice, the

---

[1] http://www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf.

[2] http://www.oecd.org/ctp/treaties/hybrid-mismatch-arrangements-discussion-draft-treaty-issues-march-2014.pdf.

[3] IFS/ETPF Conference in London on Monday 28 April on *International Taxation: Base erosion, profit shifting and distortions to real activity.*

success of any OECD solution to solve BEPS caused by hybrid mismatches will depend to a great extent on the compatibility of such a solution with the EU fundamental freedoms.

Specific comments:

Discussion Draft 2, Chapter 1: Ensuring that dual resident entities are not used to obtain the benefits of treaties unduly

The Discussion Draft proposes solving cases of dual treaty residence on a case-by-case basis rather than by reference to the current rule which uses the place of effective management of entities. The proposed wording for Article 4 (3) requires always having a mutual agreement between the contracting states.

Two major concerns arise from the consequences of this proposed requirement: (i) additional unnecessary burden on the tax authorities of the two contracting states: the mutual agreement procedure should be used as a last alternative, not first alternative; and (ii) potentially unjust to the taxpayer being subject to double taxation without fault and due to circumstances unrelated to his behaviour and beyond his influence.

Additionally, whatever the solution adopted by the OECD, it is crucial that there is simultaneous adoption by all states. In situations where an entity is resident of two states, one of which has adopted the above proposal and the second (for example, in which the entity's effective management is established) has not, the taxpayer will face double-taxation with no possibility of reprieve. Whilst it is agreed that double non-taxation is not the purpose of the treaty, double taxation is also not an acceptable result.

Discussion Draft 2, Chapter 2: Ensuring that transparent entities are not used to obtain the benefits of treaties unduly

The Discussion Draft proposes the addition of an Article 1 (2) to the Model Convention to ensure that income of transparent entities other than partnerships is treated, for the purposes of the Model Convention, in accordance with the principles of the Partnership Report.

Whilst the concept of addressing transparent entities which do not fall within the Partnership Report is understandable, this should not be addressed in Article 1 of the Model Convention, but either in the relevant provisions relating to income (Articles 6-21) or in a separate report regarding the taxation of entities that are fully or partly transparent.

Confusingly, the proposed Article 1 (2) is not referring to the tax treatment of *persons* (as the title to and current wording to Article 1 does), but refers to the taxation of the *income* (see for example paragraph 26.12 of the proposed commentary).

Moreover, from the wording of the said proposed Article 1 (2), it seems possible to envisage a situation of double taxation: Where a country A considers an entity fully/partly transparent and still taxes a part of that income, the treaty would not restrict country B from also taxing this income. The wording is very ambiguous and if the "transparent" state taxes a part of the income, double taxation could arise:
"…*income derived by or through an entity [...] that is treated as [...] partly fiscally transparent under the tax law of either Contracting State* [State A] *shall be considered to be income of a*

*resident of **a** Contracting State but only to the extent that the **income** is treated, for purposes of taxation by that State* [A or B], *as the income of a resident of that State* [A or B].”

There is no clear reference to either of the contracting states, and thus no limitation as to whether the income derived shall be considered to be income of <u>that</u> contracting state or <u>the other</u> contracting state. If an entity is <u>partly</u> transparent, it is likely still to be considered a resident of a contracting state.

Discussion Draft 2, Chapter 3: Interaction between the recommendations included in the WP11 Discussion Draft and the provisions of tax treaties

The WP 11 Discussion Draft includes the following two recommendations for domestic implementation by the residence state:

- *“Any jurisdiction that grants an exemption for dividends under domestic law should deny the benefit of such exemption if such dividends are deductible in the payer State.*
- *Any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should introduce rules that would restrict the benefit of such relief in proportion to the net taxable income under the arrangement”.*

These conditions are very difficult to prove, making these recommendations extremely burdensome in practice, as they require the tax authorities involved to check and confirm the tax treatment of the relevant instrument in the other contracting state. If this provision was adopted as proposed, it will be extremely difficult to implement it in such a way to make it reasonably effective in practice.

The proposed provisions also result in possible withholding tax obligations imposed on a resident company with respect to dividends paid to non-resident shareholders, but not with respect to dividends paid to resident shareholders, in other words it discriminates against non-resident shareholders. As mentioned above, any BEPS solution should comply with the EU fundamental freedoms and Directives.