Seminar:

Hybrid Entities; avoidance of double (non-) taxation under the Parent-Subsidiary Directive and the OECD Model Tax Convention

Conference chairman: Prof. A.J.A. (Ton) Stevens
Application of the Parent Subsidiary Directive to hybrid entities

mr. dr. G.K. Fibbe
EFS seminar
29 September 2015
Agenda

1. Application of the PSD to hybrid entities in outbound situations

2. Application of the PSD to hybrid entities in inbound situations

3. Conclusions
Application Parent Subsidiary Directive to hybrid entities

State A

State B

State C
Agenda

1. Application of the PSD to hybrid entities in outbound situations

2. Application of the PSD to hybrid entities in inbound situations

3. Conclusions
Parent Subsidiary Directive only addresses outbound situations (no. 1)
Parent Subsidiary Directive only addresses outbound situations (no. 1)
Parent Subsidiary Directive only addresses application to hybrid entities in outbound situations (no. 1)

“Member States treating non-resident corporate taxpayers as fiscally transparent on this basis should grant the appropriate tax relief in respect of revenue which forms part of the tax base of the parent company.”
Secondary EC Law

Art. 4(1, sub a) Parent Subsidiary Directive

“Nothing in this Directive shall prevent the State of the parent company from considering a subsidiary to be fiscally transparent […] and therefore from taxing the parent company on its share of the profits of its subsidiary as and when those profits arise.

In this case the State of the parent company shall refrain from taxing the distributed profits of the subsidiary.

When assessing the parent company's share of the profits of its subsidiary as they arise the State of the parent company shall either exempt those profits or authorise the parent company to deduct from the amount of tax due that fraction of the corporation tax related to the parent company's share of profits and paid by its subsidiary …”
Parent Subsidiary Directive only addresses application to hybrid entities in outbound situations (no. 1)

State A: transparent

State B: non-transparent
Outbound situations and reverse hybrid entities – not addressed in the PSD!
Following clause suggested addressing the application of the PSD to reverse hybrid entities in outbound situations:

‘In the case of an item of income, gain or capital derived through an entity established in a Member State that is fiscally transparent under the laws of that Member State where the Member State of the receiving company qualifies such entity as non-transparent, such item of income, gain or capital shall be considered to be derived by a company of the latter Member State from an entity liable to one of the taxes mentioned in Article 3 of the PSD provided – and to the extent that - the receiving company is liable to tax for that item of income, gain or capital in the former Member State to one of the taxes mentioned in Article 3 of the PSD.’
Agenda

1. Application of the PSD to hybrid entities in outbound situations

2. Application of the PSD to hybrid entities in inbound situations

3. Conclusions
Parent Subsidiary Directive in inbound situations (no. 2)
Hybrid

Company

Dividend

State A: (non-)transparent

State B: (non-)transparent
Application Parent Subsidiary Directive to hybrid entities in inbound situations

State A: non-transparent

State B: transparent

State C

Company

Hybrid

? Dividend

?
Article 2
For the purposes of this Directive 'company of a Member State' shall mean any company which:

(a) takes one of the forms listed in the Annex hereto;

(b) according to the tax laws of a Member State is considered to be resident in that State for tax purposes;

(c) moreover, is subject to one of the following taxes, without the possibility of an option or of being exempt:
- impôt des sociétés/vennootschapsbelasting in Belgium
Article 5, paragraph 1, PSD

Profits which a subsidiary distributed to its parent company shall [...] be exempt from withholding tax.

How to interpretate the term ‘distributed to’?
European Commission, 17 april 2009, no. (COM(2009)179, punt 3.3.5.2. re the Interest and Royalty Directive

“It is conceivable that one or more of the entities listed in the Annex could be regarded as fiscally transparent by a [Member State] other than that in which the entity is registered or incorporated. The Directive does not contain any provision allowing [Member States] to ‘look through’ non-resident qualifying entities. It follows that a [Member State] has no legal basis for refusing to apply the Directive to a non-resident entity which meet the requirements of Article 3.” However, even if it were permissible to apply a look-through approach, the logic of that approach would require the MS in question to extend the benefits of the Directive to the partner/shareholder. That view would be consistent with the position taken in the OECD Partnership Report and the Commentary on Article 1 of the MTC.”
Application Parent Subsidiary Directive to hybrid entities in inbound situations

State A: non-transparent
State B: transparent
State C

Dividend
Application Parent Subsidiary Directive to reverse hybrid entities in inbound situations

Hybrid

Company

State A: transparent

State B: non-transparent

Dividend

?
Article 5, paragraph 1, PSD

Profits which a subsidiary distributed to its parent company shall [...] be exempt from withholding tax.

How to interpretate the term ‘distributed to’?
Paragraph 6.4 of the OECD Commentary on Article 1 of the OECD Model Tax Convention

6.4 Where...income has "flowed through" a transparent partnership to the partners who are liable to tax on that income in the State of their residence then the income is appropriately viewed as "paid" to the partners

Source State follows allocation Residence State
OECD, ‘Neutralising the Effects of Hybrid Mismatch Arrangements’, 16 September 2014.

Article 1

PERSONS COVERED

1. This Convention shall apply to persons who are residents of one or both of the Contracting States.

2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State 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, as the income of a resident of that State. [In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State’s right to tax the residents of that State.]
OECD Tax Treaty approach to reverse hybrid entities in inbound situations

State A: transparent

State B: non-transparent

Diagram:
- Company
- Hybrid
- Dividend

State A: transparent
- Company
- Hybrid
- Dividend
Following clause suggested addressing the application of the PSD to both hybrid entities and reverse hybrid entities in inbound situations:

‘In the case of an item of income, gain or capital derived through an entity established in a Member State that is fiscally transparent under the laws of a Member State, such item of income, gain or capital shall for purposes of this Directive considered to be derived by a company of a Member State provided such item of income, profit or gain is treated for purposes of one of the taxes mentioned in Article 3 of the PSD as the item of income, profit or gain of such company in a Member State’.
Application Parent Subsidiary Directive to (reverse) hybrid entities in inbound situations
Questions?
EU approach regarding hybrid entities

September 29, 2015

Prof.dr. Arnaud de Graaf
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Classification of ‘foreign’ entities

- Countries classify entities, domestic and foreign, autonomously for tax purposes.
- As to ‘foreign’ entities, they in principle don’t take note of how other countries classify their entities.
- As the tax classification of other countries is not taken into account, differences in classification of entities occur.
- Those differences may have as an outcome situations of non-taxation and double taxation.
How do countries classify ‘foreign’ entities?

Three approaches are applied by countries:

1. Similarity approach (corporate resemblance test, application of same criteria to classify foreign entities)
2. Elective approach (so-called check-the box in US and Aruba)
3. Fixed approach (all ‘foreign’ entities are being treated as non-transparent, Italy)
Effects of not applying a symmetrical tax classification

- If a symmetrical tax classification approach would be applied, situations of double and non-taxation could be avoided.
- The non-symmetrical tax classification approaches of countries, might be (ab)used by taxpayers to optimize their tax structure.
- They might (ab)use differences in classification in order to create situations of:
  - Deduction and no inclusion (D/NI)(fig. 1 and 2; or
  - Double deduction (DD)(fig. 3)
- Especially, the elective approach enables taxpayers to minimize their tax burden.
Figure 1. D/NI (Payment to a (Reverse) Hybrid)
Figure 2. D/NI (Payment made by hybrid, disregarded by Country A)

A Co.  
+  
Interest  

B Co.  
-  
Loan  

B Sub 1  

Country A  

Country B
Figure 3. DD (Payment made by hybrid to a third party)
Effects of not applying a symmetrical tax classification

- One should also realize that differences in classification of entities might not just have as an outcome double non-taxation but also double taxation.
- Taxpayers might be unaware of a possible difference in classification.
- Figure 4 is an example of a situation of double taxation.
Figure 4. Economic double taxation because of difference …

Box II-levy and no credits

Limited partner

US individual income tax

Income form immovable property

NL

US
• Taxpayers invoked the MAP-article of DTC (taxation not in accordance with DTC)
• Claim rejected by Dutch CA. DTC only tries to avoid situations of international juridical taxation
• Outcome: international economic double taxation
• No solution, US and NL exercise their power to levy tax in parallel
HMAs: differences in tax treatment

- It is not just differences in classification of entities that create HMAs but all kinds of differences in classification between countries
- Hybrid element:
  - Taxable subject, transparent v. non-transparent
  - Tax base (broad v. narrow), e.g. financial instrument, transferal (operating v. capital lease), and permanent establishment
  - Tax rate (high v. low, for example: payment made by company in high-tax jurisdiction to a company in a tax haven)
BEPS no 2 – Recommendations for Domestic Laws

• Action 2 is only targeted at mismatches that rely on a hybrid element to produce D/NI AND DD outcomes
• Hybrid element is based on a difference in classification of entities, (financial) instruments, and transfers
• Effects of HMAs should be neutralized
Policy options to neutralise HMAs:
1. Harmonization of domestic laws;
2. GAARs;
3. Specific anti-avoidance rules; or
4. Linking rules

OECD Recommendation: linking rules, good experiences

• BEPS Action plan (2013) and 2014-Deliverable addressing the ‘problem’ whereas at the same time accepting each other’s classification
<table>
<thead>
<tr>
<th>Type</th>
<th>Arrangement</th>
<th>Specific recommendations on improvements to domestic law</th>
<th>Recommended hybrid mismatch rule</th>
<th>Response</th>
<th>Defensive rule</th>
<th>Scope</th>
</tr>
</thead>
<tbody>
<tr>
<td>D/NI</td>
<td>Hybrid financial instrument</td>
<td>No dividend exemption for deductible payments Proportionate limitation of withholding tax credits</td>
<td>Deny payer deduction</td>
<td>Deny payer deduction</td>
<td>Include as ordinary income</td>
<td>Related parties and structured arrangements</td>
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<td>Disregarded payment made by a hybrid</td>
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<td>Payment made to a reverse hybrid</td>
<td>Improvements to offshore investment regime Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque</td>
<td>Deny payer deduction</td>
<td>Deny payer deduction</td>
<td>-</td>
<td>Controlled group and structured arrangements</td>
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<tr>
<td>DD</td>
<td>Deductible payment made by a hybrid</td>
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<td>Deductible payment made by dual resident</td>
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<tr>
<td>Indirect D/NI</td>
<td>Imported mismatch arrangements</td>
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2014 Deliverable
- ECJ case law: Prohibited are obstacles caused by distinctions based on nationality and between domestic and cross-border situations
- What about obstacles resulting from disparities? Elimination only through harmonization or unification?
- Issuance by ECJ of its ruling in the *Cassis de Dijon* case, see figure 5
- If a product is lawfully produced and traded in a MS, than other MS should take account of
Figure 5. Cassis de Dijon, case 120/78

Cassis de Dijon 15 to 20%

Fruit liqueurs should contain at least 25%
Principle of mutual recognition

- Principle was also applied by ECJ in other areas, for instance
  - The recognition of diplomas (Gebhard)
  - The recognition of companies (Centros and Inspire Art)
- Also applicable in the area of direct taxation?
- Is double taxation arising from autonomous tax classification of ‘foreign’ entities incompatible with EU freedoms?
- Would it be possible for taxpayers to invoke the freedom of capital in figure 4?
Obligation to recognize the Belgium classification?

- Limited Partners
- BVBA (General Partner)
- LP

Coordination centre

Passive income
5. This assignment of the profits of a partnership to its partners applies even if the partnership is liable, as such, to corporation tax abroad, namely in the State in which it is registered.

53. In this respect, it must be recalled that the fiscal autonomy ... also means that the Member States are at liberty to determine the conditions and the level of taxation for different types of establishments chosen by national companies or partnerships operating abroad, on condition that those companies or partnerships are not treated in a manner that is discriminatory in comparison with comparable national establishments.
• EU freedoms do not offer a solution to differences in classification causing double taxation
• Only harmonizing domestic laws would offer a solution
• This path has not been taken
• Missed opportunity
• In future, international policy makers should develop entity classification rules in order to avoid all kinds of mismatches
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International aspects of fiscal transparency:
-classification of foreign entities
-application of double tax conventions

Prof. dr. Bart Peeters
Bart.peeters@ugent.be
Structure of the presentation

I. General context of classification
II. Conflicts with (reverse) hybrid entities
III. Solution for P/R – conflict?
IV. Conclusions
I. General context of classification

Entity

- Taxable income
- General purpose
- Entrepreneurial risk

Financial support

Tax payer

Bart Peeters (UGent, ULg, Uantwerpen)
Classification of an entity

Classification: **Fiscally transparent**: 1 flow of income

**Fiscally non-transparent**: 2 separate taxable flows of income
3 classifications to be fulfilled

- **Taxable income**
- **Entity**
  - General purpose
  - Entrepreneurial risk
- **State S:** source of the income
- **State P:** state of the location of the entity
- **State R:** residence state of the partner
Classification from the point of view of S

State S: -Taxing the entity or its partners ?
-Which treaty limitations have to be respected ?
(analysis for ‘inbound operations’ ?)

Bart Peeters (UGent, ULg, Uantwerpen)
Classification from the point of view of \( P \)

\textbf{State \( P \):} - Taxing the entity and distribution to the partners or immediately the partners (entity as PE?)?
- Unilateral remedies for foreign income?
- Which conventions should be applied?

Bart Peeters (UGent, ULg, UAntwerpen)
Classification from the point of view of R

State R: - When can the partners be taxed and how to qualify their income?
- Unilateral remedies for foreign income?
- Which conventions should be applied?
(analysis for ‘outbound operations’?)

Bart Peeters (UGent, ULg, Uantwerpen)
Classification from the point of view of $P$

If $S = R$: simultaneously inbound and outbound?

E.g. Dutch lawyers working for an English firm, earning domestic income

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Bart Peeters (UGent, ULg, Uantwerpen)
Classification of an entity

=> Domestic tax legislation has to be applied on
  - a domestic entity (State P)
  - a foreign entity (States S – R)

=> Classification NEEDS to be in line with
domestic tax law

=> Dealing with conflicts is a SECOND STEP
II. Conflicts with (reverse) hybrid entities

Two different classification topics:
- Which treaty limitations does a source state has to apply? (State S vs … )

- How to attribute income between conflicting residence states? (P vs R)
Source vs residence state(s)

Supremacy of a residence state compared to a clear source state: *Treaty is applicable for the source state*
- if a residence state attributes income to its own residents

Bart Peeters (UGent, ULg, Uantwerpen)
State S has to respect

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<td>Treaty S-R</td>
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<td>T</td>
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<td>No treaty</td>
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- Implicit solution in Partnership report
- Explicitly in art. 1, 6 Belgian – US treaty (2006)
- Explicit in art. 1, 2 Belgian Model convention (2007)
- No longer in Belgian Model convention (2010)
- New art. 1, 2 OECD Model ?

Bart Peeters (UGent, ULg, Uantwerpen)
Conflict between residence state(s)

**P** Entity **vs** **R** Partner

- Taxable income
- NT T NT
- HYBRID REVERSE HYBRID

Bart Peeters (UGent, ULg, Uantwerpen)
A conflict between two residence states cannot be solved by way of a predominating classification.

=> Partnership report: state R recognizes the correct autonomous application of the treaty by state P, based on its own classification.
- If P considers it may tax, state R has to grant an exemption.
- If P considers himself obliged to exempt, state R does not have to grant any exemption anymore.
If state P: NT and state R: T \( \Rightarrow \) Hybrid entity

\[ \Rightarrow \text{state P taxes income at the level of the entity} \]

\[ \Rightarrow \text{state R has to avoid double taxation through the correct application of the treaty P-R, because state P taxes the income in accordance with the terms of the convention P-R (as interpreted by state P)} \]
If state P: T and state R: NT  ➔ Reverse hybrid entity

=> state P immediately attributes the income to the partners and considers not being able to tax according to the treaty (unless PE)

=> state R does no longer have to exempt the income, as it would do based on its autonomous interpretation of the treaty P-R
solution only looks at the initial acquiring of income at the level of the entity

=> no particular treatment for the subsequent distribution from the entity to its partners

in case of a reverse hybrid entity (P:T and R: NT) state R does not have to exempt under the treaty

=> But there will be no taxation under internal income tax regulations
III. Solution for P/R-conflict?

=> needs to consider all potential taxable events in both states

È How to deal with the acquisition of the income?

È How to deal with distribution of the income to the partners?
## Hybrid entity

<table>
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<th>State P ($NT$)</th>
<th>State R ($T$)</th>
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<tr>
<td><strong>Acquiring income at the entity level</strong></td>
<td>Taxes the entity</td>
<td>Taxes each individual partner</td>
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<tr>
<td><strong>Distribution to the partners</strong></td>
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Reverse hybrid entity

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<td>Possible taxation of the partners</td>
<td>/</td>
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<tr>
<td><strong>Distribution to the partners</strong></td>
<td>No separate taxation, unless potential branch profits tax</td>
<td>Taxation of the partners</td>
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⇒ Particular clause in Belgian Model convention
Exemption of the distribution because the initial acquiring of the income has been taxed in P (art. 22, 2, b)
IV. Conclusions

- Necessary to clearly **distinguish** the topic of classification of an entity (internal tax law) from application of tax treaties (with possibly contrasting classifications)
- Any search for a solution needs to accept the fundamental **triangular character** of the topic
  (solutions are possible in bilateral double tax treaties, but need to take in mind possible taxations in a third country)
- **Recent treaties** do admit the problem of conflicting classifications, but actual clauses do not solve all the problems.

Bart Peeters (UGent, ULg, UAntwerpen)
Any questions / commentaries?

Bart Peeters (UGent, ULg, UAntwerpen)
OECD BEPS ACTION 2: New Article 1(2) of the OECD Model Tax Convention

EFS Seminar – 29 September 2015

Edward Barret
Tax Treaties Unit
OECD Centre for Tax Policy and Administration

www.europesefiscalestudies.nl
“Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; …. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention....”
Conclusions of September 2014 Action 2 Report

• A number of the treaty provisions resulting from the work on BEPS Action 6 (Prevent Treaty Abuse) may play an important role in ensuring that hybrid entities and instruments are not used to obtain the benefits of treaties unduly –
  ➢ LOB rules;
  ➢ Rules aimed at arrangements one of the principal purposes of which is to obtain treaty benefits;
  ➢ Rule aimed at dividend transfer transactions;
  ➢ Rule concerning a Contracting State’s right to tax its own residents;
  ➢ Anti-abuse rule for PEs situated in third States.

• Change to Article 4(3) resulting from the work on Action 6 will address some BEPS concerns related to dual-resident entities.

• New Article 1(2): Treaty provision on transparent entities.

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New paragraph 2 of Article 1:

2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State 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, as the income of a resident of that State.
New Article 1(2) is intended to ensure that the income of transparent entities is treated, for treaty purposes, in accordance with the provisions of the Partnership Report.

- Addresses the income of entities or arrangements that one or both Contracting States treat as wholly or partly transparent for tax purposes.
- Extends application of the conclusions of the Partnership Report to situations not directly covered by the Report.
- Provision is similar to Article 1(6) of the U.S. Model.
Applying a Convention where there is a conflict of classification:
A two-country example

Facts
P is a partnership established in State P. A and B are P’s partners who reside in State P. State P treats P as a transparent entity while State S treats it as a taxable entity. P derives royalty income from State S that is not attributable to a permanent establishment in State S.
Applying a Convention where there is a conflict of classification: A two-country example

Facts

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Applying a Convention where there is a conflict of classification: An example where benefits are not due

Facts

P is a partnership established in State P. A and B are P’s partners who reside in State R. State P treats P as a transparent entity while State R treats it as a taxable entity. P derives royalty income from State P that is not attributable to a permanent establishment in that State.
BEPS Action 2: Example (¶ 26.7 Commentary on Art. 1):

Example 4 – Yr 3 Distribution

State T

In year 3 - distribution to beneficiaries, (Bs) who are each entitled to one half of the trust's income of year 1 after deduction of administration expenses. State T taxes Bs on distributions but provides credit for tax paid at the level of the trust.

OR

Beneficiary B

40 in yr 3

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Treatment of the interest income under the A-B treaty?

- “income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent”
- State B taxes Member 1 on half of the interest
- Half of the interest shall be considered, for purposes of Article 11, to be income of a resident of State B
2006 U.S. Model Article 1(6):

“An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.”

- Identical provision in Article 4(1)(d) of the 1996 U.S. Model.
- Since the 1970s most U.S. treaties have contained provisions on partnerships/fiscally transparent entities.

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