European Business Initiative on Taxation (EBIT)

Comments on the OECD's Discussion Draft on

BEPS ACTION 2:
NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

At the time of writing this submission, EBIT Members included: AIRBUS, BP, CATERPILLAR, DEUTSCHE LUFTHANSA, INFORMA, JTI, LDC, MTU, NUTRECO, REED ELSEVIER, ROLLS-ROYCE, SAMSUNG ELECTRONICS, SCA, SCHRODERS and TUPPERWARE.

EBIT Comments on the OECD's Discussion Draft on BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

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Dear Achim,

EBIT welcomes this opportunity to provide comments to the OECD on the Discussion Draft on BEPS Action 2: "Neutralise the effects of hybrid mismatch arrangements" which was issued on 19 March 2014 (hereinafter "the Discussion Draft").

General Comments

EBIT supports the OECD's work to address cross-border hybrid mismatch arrangements and we generally acknowledge the political importance and sense of urgency attached to Action 2 of the BEPS Action Plan.

We support proposals aimed at mitigating the valid concerns of the G20 and OECD about highly structured artificial arrangements to exploit mismatches between tax jurisdictions. At the same time, such rules should not give rise to double taxation and other unintended consequences for genuine cross-border businesses and they should ensure a level playing field, and coherent international tax system.

EBIT welcomes the fact that the OECD acknowledges in its Discussion Draft that hybrid mismatches arise as a result of governments taking different positions on the taxation of hybrid instruments or entities, and that it is frequently difficult or impossible to identify which government has suffered loss. As in much of the BEPS project, this is not a case of tax avoidance as previously understood; there can be no avoidance where there is no intent to tax in the first place. The tools to deal with non-taxation will not be the same as those used for avoidance. This should be remembered in particular where penalty and interest regimes are involved.

A key point in our view is that international co-operation is paramount in addressing the issue of hybrids. If all 42 states supporting the BEPS project do not adopt measures to ensure single taxation of hybrids, there is potential for substantial tax asymmetry to remain for companies resident in those non adopting states as well as potentially in countries not participating in the BEPS project. This could lead to distorted tax competition. We anticipate that this may be a particular issue with hybrids involving entity classification, where it may be difficult for certain states to change their domestic rules. This might lead to a situation where some of the states initiate partial measures, some none at all and some comprehensive measures, leaving continuing opportunities for companies resident in the states with no or partial measures to receive a "subsidy" from the international tax system not available to those in states where the measures are comprehensive. It could also lead to increased disputes over the balanced allocation of taxing rights across jurisdictions. Because of this risk, the OECD should be providing guidance or recommendations on implementation from an agreed future date to allow coordinated action.

Adding to the previous point, with regard to hybrid financial instruments, EBIT notes that the OECD's proposed counteraction is not consistent with the work undertaken in the context of the EU. The EU is about to finalise a revision of its EU-wide Parent Subsidiary Directive, which was announced in November 2013 as part of the EU's December 2012 Action Plan to combat tax fraud and tax evasion and aggressive tax planning within the EU. The EU Parent Subsidiary Directive proposed changes provide that where a parent company, by virtue of its association with its subsidiary, receives distributed profits, the EU Member State of the parent company shall refrain from taxing such profits only to the extent that such profits are not deductible by the subsidiary of the parent company. This solution will now be incorporated into all national laws across the EU by 31 December 2015 at the latest. We are concerned that the EU and OECD are recommending inconsistent solutions to the same problem since the EU counteraction focuses on the recipient, whereas the OECD counteraction focuses on the payer country. We would not wish for "double jeopardy" for taxpayers whereby EU law prescribes recipient countries to tax profits on hybrid instruments whilst the OECD simultaneously requires the payer countries to disallow them.

The proposed anti-hybrid recommendations in the Discussion Draft would give rise to another EU Law problem. As the new rules will be implemented as domestic anti-abuse rules, under EU Law (i.e. the free movement of capital rules and settled case law of the EU's Court of Justice including *Test Claimants in the Thin Cap Group Litigation* (C-524/04: see in particular paragraph 92) and *Itelcar* (C-282/12), this would trigger a "commercial purpose" justification with regard to the anti-abuse test i.e. that the taxpayer must be allowed to demonstrate that the arrangement had been adopted for commercial reasons and not solely for tax reasons. EBIT is concerned that this test is compulsory only in the 23 EU/EEA OECD countries supporting BEPS, and will lead to different (tougher) anti-abuse standards being applied with respect to anti hybrid mismatch rules within the EU/EEA region than elsewhere.

EBIT notes that a distinction is drawn by the OECD in its Discussion Draft between the tax effects of hybrid arrangements and other types of mismatches resulting from the fiscal policies of different countries. Hybrid arrangements are only one of the factors that can result in cross-border tax mismatches. Yet the OECD does not really provide a rationale for why it has decided to focus on hybrid mismatches. For example, tax rate differences affect location decisions, but this is a fundamental aspect of countries' sovereignty and tax competition and as such out of scope. In our view rationalising why other types of mismatches are (rightly) not under consideration as well is crucial to making the anti-hybrid proposals more proportionate and more targeted.

The OECD's work on hybrids should also be closely coordinated with the work on CFCs (Action Point 3), Interest Deductions and other Financial Payments (Action Point 4), and also Harmful Tax Practices (Action Point 5), however, the OECD is not scheduled to report until September 2015 on these Action Points. To ensure that the OECD sticks to its holistic approach and proposes proportionate and well-balanced final recommendations which do not create unintended consequences or an un-level playing field and take the impact of the proposals under these other BEPS actions fully into account, we urge the OECD not to finalise its work on Hybrids in advance of its work on CFCs, Interest Deductions and Harmful Tax Practices.

From our daily experience, it seems to us that the intrinsic highly technical and practical complexity associated with the anti-hybrids rules, the associated administrative compliance aspects for taxpayers and tax administrations, and the related uncertainty and scope for unintended ramifications of the rules, are either being misjudged or downplayed by the OECD. Two examples can illustrate this point. First, due to their wide scope, the proposed rules imply that taxpayers who are part of a genuine international business not engaging in hybrid mismatch arrangements would nevertheless be required to confirm that all their routine commercial transactions are outside the scope of the proposed anti-hybrid rules. It is obvious that such a provision would impose a significant extra administrative compliance burden on taxpayers without exception and that the rules will distort international competition, trade and investment flows. Secondly, in the recommendations for domestic laws in the Discussion Draft, a taxpayer's claim to a deduction or inclusion is linked to whether a deduction or inclusion is granted or required in another jurisdiction. This would mean that taxpayers would be required to assess how the arrangement is to be treated in their domestic jurisdiction and also be aware of how it is to be treated in the jurisdiction of their counterparties, i.e. information is to be obtained from third parties or entities that are not within their control. These above two examples illustrate that it is critical that the draft rules be re-designed in order to be workable for taxpayers and to keep the compliance costs to a minimum.

EBIT is strongly in favour of a bottom up approach, because as tax practitioners, we firmly believe that a top down approach, where all hybrids are within scope unless specifically excluded, would be very difficult and costly to manage in practice.

EBIT considers that the affiliation threshold applying to a related party should be based on the notion of control, in this case the ability to obtain the necessary compliance information from the affiliate. The threshold should therefore be set at either 50.1% or at a minimum 25% instead of the proposed 10% because otherwise compliance will be made disproportionately burdensome, in particular for Joint Ventures and collective investment vehicles.

EBIT is concerned about the proposals with regard to reverse hybrid situations. To illustrate: if the investor jurisdiction (country A) and the investee jurisdiction from which payment is ultimately made (country C) both decide neither to include that payment (A) nor to disallow the deduction (C), should an intermediate third country (B) from which there is maybe a non-hybrid payment to country A, be automatically required to disallow the deduction under the proposed rules? The intermediate country B is being required to disallow a payment to the ultimate investor country A where neither the primary rule is applied, i.e. investee country C payer disallows, nor the secondary rule, i.e. ultimate investor country A taxes. If the latter (Country A) is the US for instance, as reverse hybrid situations are almost always US outbound, they may well not tax because of either check-the–box or the scope of Subpart F. Hence, in our view this could potentially export US/investee country non-compliance with hybrid counter-action to the intermediate country.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this area. We are happy to discuss and remain committed to a constructive dialogue with the OECD.

Yours sincerely,

The European Business Initiative on Taxation – May 2014

For further information on EBIT, please contact its Secretariat via Bob van der Made, Tel: + 31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com).

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