Enclosure

Comments to BEPS ACTION 2: neutralise the effects of hybrid mismatch arrangements

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Box 1.:

Q 1. Are the objectives and design principles of the hma's clear?

Response: no.

Q 2. Where is further qualification required and how could it best be provided?

Response and recommendations:

We believe that hybrid mismatch arrangements (hereinafter: hma's) should only be countered for tax purposes if they are abusive in the sense that they serve no other purpose than to avoid taxation in one of the member states involved. In practice, however, an hma is more often a disparity than a deliberate tax avoidance scheme. One good example is the "quasi tear 1 capital instrument". These instruments, introduced by and for banks and financial institutions, can be described as a form of note issue on a stock exchange with hybrid conditions comparable with the hybrid conditions mentioned in this BEPS ACTION 2. They have been developed to ensure that banks or other financial parties fulfill the minimum core capital equity requirements introduced by the authorities. The instrument is also called *"quasi tier 1 capital"*, because it is materially most akin to equity but is legally still qualified as a loan. The instrument is likely to be considered an hma, although it is clear that a quasi tier 1 hybrid instrument is not intentionally set up for tax reasons and that, considering the open character of the instrument, it is very difficult to verify whether mismatch tax consequences exist.

Furthermore, we believe that abusive hma's should only be scrutinized in and by the country who suffers from the tax avoidance by means of a tax revenue decrease. In our experience this is normally the source (activity based) country, rather than the resident (shareholder's) country. If the source country chooses to allow a deduction for payments on an hmi, regardless of the tax treatment in the residence country of the investor, this should be assumed a conscious decision by the source country based on its national sovereign tax policy. Requiring the residence country of the investor to tax payments on an hmi in such cases would violate the generally and internationally accepted, fundamental principle of

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territoriality: it is the source country where the funds are used to finance the activities which generate taxable profit, and it should be the source country to decide whether or not to tax (or whether or not to allow a deduction). Requiring the residency country of the investor to tax may very well mean conferring a right to tax to a country where there is little to no substance and little to no activity that would justify taxation in that country.

The problem of double non-taxation potentially caused by hma's can only by solved through harmonization and/or coordination of domestic(tax) rules if this takes place globally. Otherwise, abusive hma's will find their way to non-participating countries.

We firmly believe that imposing adjustments to national law is not the solution, the solution should be found in bilateral- or multilateral tax treaty negotiations, resulting in adequate enforcement of the arm's length principle and exchange of information.

We believe that countries already have a broad range of tools at their disposal enabling them to levy and collect their fair share of taxes:

1. Transfer Pricing rules

- If debtors in an hma pay a non arm's length interest amount, tax authorities of the debtor's Country may refuse deductibility of interest to the extent that the interest payment is not at arm' s length;
- The debtor's country may even argue to wholly or partially requalify a debt as equity if the debt materially equals equity
- Other hma's (e.g. use of hybrid entities) may be countered through arguing that the hybrid entity in the residence country can not be considered economic owner of the asset due to a lack of substance and control; such hybrid entity may then be disregarded by the source country.

2. Permanent Establishment (pe) profit allocation rules

Recently the OECD has introduced the new rules (as mentioned in Art. 7 of the OECD model-treaty) regarding allocation of income to pe's, the so-called Authorized OECD Approach (hereinafter: AOA). The AOA rules determine that the allocation of profit to a pe should be (more) in line with the allocation of profit to entities. Therefore, there should be an analytic (compare with TP functional analysis) approach which uses the functions performed, assets used and risks assumed as a base. This approach should enable a country on which territory activities are performed (territorial principle of taxation) to tax its fair share, i.e. by arguing that the hybrid entity may have a pe on its territory and that the AOA-rules apply.

3. Transparency rules

At several occasions (OECD harmful tax competition/EU Code of Conduct) countries have agreed that tax (and other) rules and tax (and other) information should be shared freely and

spontaneously between treaty partners. Therefore, OECD member states should have enough knowledge of each others tax systems and tax rules to take their well balanced decision on how to treat foreign hma's in their domestic (tax) law.

4. Exchange of information

In order to be able to tax their fair share in a globalised economy, where taxpayers have the possibility to allocate income in territories where information is undisclosed, it is clear that an efficient system of exchange of information is crucial for tax administrations around the world. Today almost all countries in the world have embraced this exchange of information. Especially as far as corporate income tax is concerned. Therefore, tax authorities should, with the instruments already available, be able to have or obtain all the necessary information to also levy their fair share.

These are fair rules laid down in formal and informal bilateral and multilateral tax treaties and (to a large extent) based on OECD models, which should be fairly enough for both source countries and residence countries to levy their fair share of tax.

Finally, if hma's are to be banned, we wonder why are notional interest deduction schemes allowed? This distorts the level playing field between countries who stimulate their economies through hybrid instruments (e.g. Brazil/Australia) and countries who stimulate their economies through (deemed) interest deduction on equity (e.g. Belgium).

Box 2. Questions for Consolation

1. Is it clear what elements need to be present in order for the rules neutralizing hybrid financial instruments (hfi's) or hybrid transfers to apply?

No, the rule order is very unclear: E.g. Par. II.17 more or less defines a mismatch as a mismatch. This is not really explanatory language. We would be interested to learn what, according to the OECD, is the international definition of a hybrid instrument.

Primary and defensive rules:
1. "jurisdictions should deny a deduction for any payment made under a hybrid financial instrument" (primary rule) and
2. "A dividend exemption should not be granted" (defensive rule).

If these rules would be applied independent of one another (which could be the case, in practice), it would result in double taxation. The defensive rule is unnecessary if the primary rule is applied. But if the source country does not apply the primary rule, it should be considered the source country's intended decision, the residence country should not interfere.

The commentary says that the focus of the rule is on the mismatch and not on the country who suffers the loss of tax revenue caused by the mismatch. However, to us it seems that the arm's length allocation of income principles should be decisive. The hma rules contravene the much more fundamental arm's length principle.

4 (a)

What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration?

Both approaches lead to uncertainty for taxpayers because tax authorities can choose whichever approach deemed necessary to counter hfi's: if the other country allows interest deduction, they tax the corresponding income; if the other Country does not allow a deduction, they are allowed to tax also (classical tax systems). Therefore, the basic rule to counter hfi's should simply be exchange of information (current system) based upon which both countries can decide what to do. But is should be within the control, responsibility and authority of the source country and not of the other country, because the decision of (non) deductibility is a unilateral one and not a bilateral one. Only if the decision leads to double taxation the countries may choose to enter into a mutual agreement procedure (MAP).

5 (a)

It is very difficult to qualify financial instruments in advance. By doing so the commercial investment climate (funding of investments) for companies might be influenced negatively.

6 (b)

Debt issuers, Merchant bankers and other parties involved in the financial market may find it very difficult to qualify financial instruments as being “safe” or not. To protect investors and issuers from severe tax consequences, even more comprehensive studying than is currently the case, would be necessary to qualify the instrument accordingly. This leads to unnecessary delay on the financial markets and causes potential lack of economic growth.

5 (c)

Yes, we refer to (b)

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The fundamental rule should be: exchange of information (please compare with EU Savings directive)

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See our comments under Box 2 regarding quasi tier 1 instrument.

Box 3.

1. Is it clear what elements need to be present in order for the rules neutralizing deductible hybrid entity (dhe) payments to apply?

Yes.

2. Is the outcome of the rule operation clear?

No. When does the stranded losses rule apply? Is the taxpayer required to convince the tax inspector of country A that he was not able to use all losses in country B? What if both countries use different methods for determining the tax base? These rules should be clarified in much more detail. Again the solution is should be: if country A and country B are well informed about the facts, they may curb the mismatch or not, as long as they are in a position to do so. It should be up to the authority's own choice to implement such rule or not.

Box 4 and 5 (Reverse hybrids)

We refer to our comments on hma's, which also apply to reverse hybrids.

Comment BEPS Action 2 (**treaty issues**)

Paragraph 20/22

It seems that the new article favors the credit method as the applied method to prevent double taxation rather than the exemption method. We think that both methods at least should be of the same ranking. It is up to the treaty (and therefore also the model treaty) to allocate income and it is - after allocation - up to the country who has been granted allocation to tax or not to tax. It is not for the Country who gives up taxing rights to interfere with the receiving Country's system of taxation. Vice versa, it is not for the receiving Country to interfere with the system of the granting Country, as long as double taxation is prevented.

Conclusion

Our key comment is that the fundamental solution to abusive hma's should be found in consistent and correct application of the at arm's length principle as set out in the OECD Model Convention, and the OECD's own transfer pricing guidelines, in conjunction with the application of the OECD's exchange of information standard. In the presence of adequate exchange of information, the arm's length principle provides tax administrations all the necessary instruments to correct undesirable tax consequences of hma's. If, in spite of exchange of information and the at arm's length principle, the source country chooses to allow a deduction for payments on an hmi, this should be assumed a conscious decision by the source country based on its national sovereign tax policy. Requiring the residence country of the investor to tax payments on an hmi in such cases would violate the generally

and internationally accepted, fundamental principle of territoriality. In other words, the OECD has already provided for the full array of measures to adequately counter abusive hma's. It is up to the member states to make full and appropriate use of these measures.