Council of the
European Union

Brussels, 13 June 2016
(OR. en)

9912/16

FISC 97
ECOFIN 558

REPORT

From:	Code of Conduct Group (Business Taxation)
To:	Permanent Representatives Committee/Council
Subject:	Code of Conduct (Business Taxation) – Report to the Council

I. INTRODUCTION

(a) Background

1. On 1 December 1997, the Council and the Representatives of the Governments of the Member States, meeting within the Council, adopted a Resolution on a Code of Conduct for business taxation. This Resolution provides for the establishment of a Group within the framework of the Council to assess tax measures that may fall within the Code.

2. In its conclusions of 9 March 1998 (doc. 6619/98), the Council confirmed the establishment of the Code of Conduct Group. The Group reports regularly on the measures assessed and these reports are forwarded to the Council.

3. The Code of Conduct provides that the Group reports "*will be forwarded to the Council for deliberation and, if the Council so decides, published*". Furthermore, the March 1998 Council conclusions indicate that these reports will reflect either the unanimous opinion of its members or the various opinions expressed in the course of the discussion. The procedural elements that were part of the 2008 Work Package (doc. 16410/08) further detailed that the report to ECOFIN can indicate the number of Member States concerned without qualifying their views and be edited in such way that ECOFIN can have a "*clear and focussed discussion on the key elements at stake*".

4. In accordance with the Procedural Aspects of the Group (16410/08), the Group should maintain to aim at a (broad) consensus to reflect the positions of the Member States in the Group in its reports to ECOFIN, to avoid losing the effectiveness of the Group, while respecting the principle of unanimity as laid down in the Council conclusions of 9 March 1998 concerning the establishment of the Code Group. In the case broad consensus cannot be reached, the Group's reports can express the various views mentioned.

5. In its Conclusions adopted on 8 March 2016 (doc. 6900/16), the Council "*calls for having more substantial 6-monthly Group reports to ECOFIN, reflecting the main elements and views, which were discussed under specific items and reporting also on the monitoring concerning (non-) compliance with agreed guidance*" (paragraph 16).

6. This report from the Code Group encompasses the work of the Group in 2016 under the Netherlands Presidency.

(b) Progress of work

7. The Code of Conduct Group met on 2 February, 12 April and 2 June 2016 under the Netherlands Presidency. The Group continued the work on the basis of the new Work Package adopted in November 2015 (doc. 14302/15, Annex 3).

8. At the meeting of 2 February 2016 the Group confirmed a programme of work under the Netherlands Presidency, agreeing to take forward work in the following areas:

(a) continue its work on rollback;

(b) continue existing work on standstill;

(c) continue work on the various aspects of the Group's Work Package 2015.

9. It was clarified that the taxation of outbound payments would also be examined during the Netherlands Presidency.

(c) Appointment of vice chairs

10. Pieter Hasekamp (Netherlands) and Lineta Furek (Slovakia) were confirmed as respectively the first and the second Vice-Chairs for the period up to the end of the Netherlands Presidency.

II. STANDSTILL AND ROLLBACK

(a) Standstill

(i) <u>Patent Boxes</u>

11. Member States were consulted about the areas of doubt concerning the way the nexus approach should be applied before any draft assessments are submitted by the Commission Services to the Group. These clarifications related to:

- the relationship between the nexus approach and the criteria of the Code, particularly the relationship between criteria 3 and 4;
- the treatment of losses arising from intangible property ("IP") in a patent box;
- the identification of embedded royalties, and;
- the enhanced transparency .

12. Following a first round of discussion which took place on 2 February and in the light of written comments from several Member States, the Commission Services presented draft guidelines on the interpretation of the nexus approach.

13. The draft guidelines covered five issues:

    A. Relationship between the nexus approach and the Code criteria;

    B. Overall income;

    C. Treatment of losses arising from assets in an IP regime;

    D. Embedded royalties;

    E. Enhanced transparency requirements.

14. A first draft was discussed at the meeting on 12 April and the Group decided that the Commission Services would present a revised version of the guidance at a future meeting. It was also agreed that the Commission Services would seek the advice of Member States' delegates in the EU Joint Transfer Pricing Forum regarding embedded royalties.

(ii) <u>Other measures</u>

15. Two Member States notified measures which potentially fall within the scope of the Code. Croatia notified to have enacted a new Act on Investment Promotion which replaced the previous Act on Investment Promotion and Improving the Investment Climate. The Netherlands notified the Group of some amendments made by Aruba (one of the fiscal autonomous countries within the Kingdom of the Netherlands) to its Imputation Payment Company (IPC) regime.

16. As clarification is needed on some aspects of those measures, it was agreed that the Commission services would follow up on those issues bilaterally with the Member States concerned and report back to the Group at the earliest opportunity.

(b) Rollback

(i) Patent Boxes

17. In November 2014 the Group agreed, in co-ordination with developments at the OECD, on the modified nexus approach as the appropriate method to ensure that patent boxes require sufficient substance. The Group agreed that the EU patent box regimes which had been subject to examination by the Group are not compatible with the modified nexus approach. As a consequence, these EU patent boxes should be changed in line with the compromise.

18. The Council Conclusions of 11 December 2014 emphasised the need for Member States to start in 2015 the legislative process necessary to change the patent box regimes and asked the Group to monitor this process. Member States which currently have patent boxes needed to begin the legal processes to close the regimes to new entrants from the end of June 2016 and end all benefits for existing claimants by June 2021.

19. The Group agreed in 2015 that the relevant Member States should submit a report on this issue with their annual notifications of rollback at the Group's first meeting in 2016.

20. During the Netherlands Presidency, all Member States which currently have patent box regimes, except France, have notified the Group of the steps taken to comply with their commitments. In the meeting of 2 June 2016 France declared that no rollback would be necessary since it considered that its regime would not be harmful. The Group asked France to demonstrate the compatibility of its Patent Box regime with the modified nexus approach[1].

[1] When it is examined, FR considers it has to be seen in a broader perspective, taking into account in particular the level of taxation, to appreciate its non-harmful character.

21. Out of the ten Member States which sent rollback notifications on patent boxes, eight Member States have either prepared draft legislation or already enacted relevant legislation to adapt their existing legal frameworks on patent boxes so as to comply with the commitments. The same is true for Spain regarding their national regime and three of their sub-national patent box regimes (Álava, Gipúzcoa and Vizcaya (Basque Country)).

22. Italy has notified the Group that an internal consultation is ongoing in relation to the necessary provisions to adapt the existing legislative framework in order to fully comply with the minimum standard on IP regimes and that, in the meantime, some minor amendments have been made to the existing patent box regime.

23. Similarly, Spain has declared that Navarra has started the work which is necessary to amend the existing sub-national patent box regime so as to comply with the "modified nexus approach" developed by the OECD and agreed by the Code of Conduct.

24. The Netherlands has started the legal process to align its regime with the modified nexus approach. The amendment will apply from 1 January 2017. The fact that this amendment will not already apply from 1 July 2016 should not entail that it will be harmful since no grandfathering would be allowed for IP assets developed after 30 June 2016. The Netherlands declared that this will not pose a problem in practise and it is acting in accordance with the modified nexus approach of the OECD.

25. The Group will continue its work on rollback on the existing patent box regimes and reiterates the need to close all existing patent boxes for new entrants by 30 June 2016.

(ii) UK: Gibraltar – Income Tax Act 2010

26. At the meeting on 2 February 2016, the Group decided to ask the Commission Services to prepare a draft assessment of the treatment of the asset holding companies under Gibraltar's 2010 Income Tax Act ("ITA10"). This draft assessment was presented at the meeting on 12 April 2016.

27. After the draft assessment has been circulated to the Group, the UK and the Government of Gibraltar were given the opportunity to provide additional factual information about the companies' income for the final assessment. The Group considered part of the regime as harmful, as it was pre-assessed by the Commission services.[2] [3]

III. ANTI-ABUSE – MISMATCHES

28. At its meeting on 23 July 2015, the Code of Conduct Group agreed to focus as a first step on third country aspects of hybrid entities and hybrid permanent establishments. The guidance and explanatory notes on hybrid entity mismatches involving third countries was finalised under the Luxembourg Presidency in November 2015.

29. Under the Netherlands Presidency, the Subgroup met on 27 January 2016 to continue work on a draft guidance and explanatory notes on hybrid permanent establishment (PE) mismatches involving third countries and, following a silence procedure, agreed on the draft guidance.

30. On 2 June 2016, the report of the subgroup was submitted to the Code of Conduct Group and the guidance and explanatory notes on hybrid permanent establishment mismatches involving third countries were approved by the Group (see Annexes I and II).

---

2 Spain agrees with the outcome of the Group`s assessment. Nevertheless, Spain considers that this assessment is insufficient and certain aspects require further works, in particular the tax treatment of capital gains and the transparency problems because of lack of tax information (Room document #11 Code of Conduct Business Taxation meeting of 2 June 2016).

3 The UK reiterates that these conclusions are based on limited evidence, and should be reviewed once additional information about asset-holding companies becomes available.

31. The Group decided to wait for the outcome of the legislative process on the proposal for an Anti-Tax Avoidance Directive (ATAD) before deciding on possible further work.

IV. ADMINISTRATIVE PRACTICES

(a) Implementation of the Model Instruction on the exchange of information relating to rulings and unilateral advance pricing agreements

32. In advance of the discussion on the implementation of the Model Instruction on the exchange of information relating to rulings and unilateral advance pricing agreements at the Group meeting on 12 April 2016, the Chair circulated an updated questionnaire on the matter, relating, in particular, to the type of rulings issued, the implementation of the Model Instruction and the number of information on rulings exchanged or received. The state of play on the implementation of the Model Instruction within the Member States was presented to the Group by the Commission Services at the meeting on 12 April 2016.

33. 25 Member States sent their updated replies to the questionnaire, 3 Member States' replies[4] are still missing. The latter group, however, provided an oral update during the meeting. According to the replies to this updated questionnaire 18[5] MS have implemented the Model Instruction. 8[6] have not implemented the Model Instruction but are in the process of doing so. Two Member States did not reply to the updated questionnaire but have indicated that they have implemented the Model instruction[7]. The group reiterated that the implementation should have taken place as from 1 January 2016 and calls on the Member States which have not yet implemented the Model instruction to do so without delay.

---

4 ES, FR and PL.
5 AT, BE, BG, CZ, DK, EE, FI, HR, HU, IE, IT, LT, LU, MT, NL, SI, SK and UK.
6 CY, DE, EL, LV, SE, PL, PT and RO.
7 ES and FR.

(b) Guidelines on the issuing of tax rulings

34. As part of its 2015 Work Package the Group has agreed to develop a set of guidelines on the conditions and rules for the issuance of tax rulings, that is standard requirements for good practice by Member States based on general principles. The development of these guidelines also forms part of the Group's work programme under the Netherlands Presidency.

35. At the meeting on 12 April 2016, draft guidelines on the conditions and rules for the issuance of tax rulings were discussed. They cover the process of granting a ruling, the term of the ruling and subsequent audit/checking procedure and the publication and exchange of information. The Commission Services have prepared a revised version of the draft, taking into account comments made by Member States.

36. This revised version was discussed at the meeting of 2 June 2016. In the light of new issues raised by Member States further work is needed.

(c) Monitoring guidance on inbound profits

37. The Group endorsed guidance on Inbound profits in 2010 (doc. 16766/10). The guidance requires Member States that grant a corporate tax exemption on foreign source dividends (in intercompany situations) to apply either effective anti-abuse provisions (e.g. CFC rules) or a switch over provision (i.e. a provision according to which, under certain circumstances, relief from double taxation is granted via the credit method rather than by means of exemption). The objective is to ensure effective taxation of inbound profits.

38. The monitoring of the implementation of these guidelines has started in February 2012 and has continued in the following years.

39. It was agreed that work in this area should be carried out by using a "tool box" approach. The Commission Services developed two separate check lists, one for switch over provisions and another for CFC rules, which would enable it to make an assessment on whether an appropriate legal framework is in place as well as on its effectiveness. The check lists were discussed at the Group meetings on 22 October 2014 and 4 February 2015. Based on these check lists, at the meeting on 4 February 2015, the Commission services made a preliminary assessment of Member States' anti-abuse provisions.

40. At the Group meeting on 2 February 2016, the Commission Services presented a preliminary assessment of the effectiveness of Member States' anti-abuse provisions. Given the strong links between the topic at issue and the Commission proposal for an Anti-Tax Avoidance Directive (ATAD)[8], it was agreed that the ongoing discussions on ATAD should be taken into account and that the work will be completed as soon as possible.

V. OUTBOUND PROFIT TRANSFERS

41. In the new Work Package 2015, it is stated that "*the Group will consider the question of outbound payments. Its initial work will involve the identification of potential problems which arise when payments are made from the EU to a third country*".

42. To this end, the Group had a discussion at its meeting on 12 April 2016 on the basis of an analysis of the Commission Services which concluded that uncoordinated interaction of the Member States' national policies as regards the taxation of outbound profit distributions seems to act to the detriment of their tax bases. It was suggested that it would be appropriate to include Interest and Royalties in the scope of the discussion. The Commission Services was invited to provide a new document along those lines. Member States were invited to contribute to such a document by providing examples.

[8] Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (COM (2016) 26 final).

VI. LINKS TO THIRD COUNTRIES

(a) Liechtenstein

43. Following the presentation made by Liechtenstein at the meeting of the Code of Conduct Group on 21 October 2015 and the ensuing exchange of views between Member States, the Commission Services provided a preliminary analysis of the compatibility of the relevant measures with the Code of Conduct for business taxation for the meeting of the group on 18 November 2015. The Group invited the Commission Services to continue its dialogue with Liechtenstein with regard to the following five measures:

– the full exemption for dividends and capital gains on participations;

– the exemption for capital gains combined with a tax deductible write down/value adjustment;

– the special regime for Private Asset Structures (PAS);

– the Liechtenstein royalty box; and

– the Liechtenstein notional interest deduction regime.

The group also invited the Commission Services to include the issue of Liechtenstein tax rulings in the dialogue.

44. The Commission Services informed the Group on the state of play of the dialogue with Liechtenstein at the meeting of 2 June 2016. It was agreed to invite Liechtenstein to a forthcoming meeting in Autumn 2016.

(b) External strategy of the EU

45. In January 2016 the Commission presented an External Strategy for Effective Taxation to promote tax good governance internationally. The External Strategy includes an EU listing process to identify and act against third countries that fail to comply with tax good governance standards. The External Strategy sets out a 3-step process for developing a common EU list.

46. The ECOFIN in May 2016 endorsed the EU listing process and invited the Code of Conduct Group *"to start work on an EU list of non-cooperative jurisdictions by September 2016 and to determine, on the basis of a first screening by the Commission, third countries with which dialogues should start, with a view to establishing an EU list of non-cooperative jurisdictions and exploring defensive measures at EU level to be endorsed by the Council in 2017"*. As regards the criteria to be used for establishing the list of non-cooperative jurisdictions, the Council decided that *"the criteria on transparency have to be compliant with internationally agreed standards on transparency and exchange of information for tax purposes, in particular standards developed by the OECD"* and invited the Code of Conduct Group *"to consider an additional criterion based on the non-existence of harmful tax regimes as defined by the criteria of the Code of Conduct on Business Taxation"* and *"possible additional criteria which could be inspired in particular by the OECD BEPS actions"*.

47. On 2 June 2016, the Commission Services presented to the Member States the scoreboard of indicators which is aimed at identifying third countries which should be prioritised for screening by the EU.

48. It was agreed that, in order for the Code Group to respond timely to the invitation made by ECOFIN, the Code subgroup on third countries[9] should meet in July to prepare the ground. Its work will focus on: (1) the preselection of the third countries to be prioritised for screening; (2) the identification of the additional criteria to be used in the screening process and (3) potential counter measures.

---

[9] Doc. 6674/16 FISC 33 ECOFIN 189

ANNEX I

Guidance on Hybrid Permanent Establishment Mismatches concerning a Member State and a third state

1. For the purposes of this Guidance, which applies to the extent that a mismatch situation concerns a Member State and a third state.

1.1. a *permanent establishment* is treated as *hybrid* where the business activities of an enterprise:

1.1.1. are not recognised as carried on through a permanent establishment in the state where those activities are carried on (the state of source) but are recognised as carried on through a permanent establishment in the state where the enterprise is a resident (the state of residence), or

1.1.2. are recognised as carried on through a permanent establishment in the state where those activities are carried on (the state of source) but are not recognised as carried on through a permanent establishment in the state where the enterprise is a resident (the state of residence);

1.2. a *mismatch situation* for a Member State and a third state, in relation to a hybrid permanent establishment, is where the mismatched treatment by the two states of business activities of an enterprise as carried on through the permanent establishment is relevant to the treatment for tax purposes of profits from business activities of the enterprise;

1.3. *non-taxation without inclusion* arises where the profits from business activities are not taxed in the state of source as such activities are treated as not being carried on through a permanent establishment, while those profits are exempt from tax in the state of residence as profits attributable to a permanent establishment;

1.4. a *double deduction* arises where a deduction or other tax relief is given in each of two states for the same payment, expense or loss attributed to a hybrid permanent establishment, insofar as that payment, expense or loss is deducted from or relieved against income that is not attributed to the hybrid permanent establishment;

2. Where as a result of a mismatch situation for a Member State and a third state, in relation to a hybrid permanent establishment:

2.1. a non-taxation without inclusion would otherwise arise, then, for the purpose of preventing the non-taxation without inclusion,

2.1.1. where the third state treats the business activities concerned as if they were not being carried on through a permanent establishment the Member State concerned should treat the business activities concerned as if they were not being carried on through a permanent establishment, 2.1.2. where the third state treats the business activities concerned as if they were being carried on through a permanent establishment the Member State concerned should treat the business activities concerned as if they were being carried on through a permanent establishment,

or

2.2. a double deduction would otherwise arise, then, for the purpose of preventing the double deduction,

2.2.1. where the third state treats the business activities concerned as if they were not being carried on through a permanent establishment the Member State concerned should treat the business activities concerned as if they were not being carried on through a permanent establishment,

2.2.2. where the third state treats the business activities concerned as if they were being carried on through a permanent establishment the Member State concerned should treat the business activities concerned as if they were being carried on through a permanent establishment,

2.2.3. where the third state treats the business activities concerned as if they were being carried on through a permanent establishment and a double deduction still occurs where the Member State concerned treats the business activities concerned as if they were being carried on through a permanent establishment that Member State should remove the double deduction by denying deductions to the company carrying on the business activities that give rise to the mismatch,

notwithstanding the treatment of such activities or amount that would otherwise apply.

3. A business activity should be treated as being carried on through a permanent establishment or not, in accordance with this guidance and contrary to the treatment that would otherwise apply, only to the extent that is necessary for the purpose of preventing a double deduction or non-taxation without inclusion that would otherwise arise – taking into account other rules that neutralise the effects of hybrid mismatches – and not for any other purpose.

Explanatory notes on the Guidance on Hybrid Permanent Establishment Mismatches concerning a Member State and a third state

These notes are arranged in the order of the relevant paragraphs of the text of guidance.

- ***General comment on format of the draft text***

Paragraph 1 and its four subparagraphs set out the meaning of certain terms for the purposes of the guidance. *Paragraph 2* does the main work of the guidance - specifying an alignment of treatments of hybrid permanent establishment ("HPE") where mismatched treatments would otherwise result in non-taxation without inclusion or a double deduction. *Paragraph 3* ensures that this alignment cannot be used to achieve unintended results: it is solely to prevent *non-taxation without inclusion and double deduction* and is applied for dealing with mismatch situations, to the extent that they are not tackled otherwise.

- ***Paragraph 1 - introductory line***

1. For the purposes of this Guidance, which applies to the extent that a mismatch situation concerns a Member State and a third state

These introductory words serve the following purposes:

They signal that the meanings of terms set out in the *paragraph 1* and *its subparagraphs* are for the purposes of the guidance only and are not intended to have any wider significance.

They also signal that the application of the guidance, in addressing mismatched treatments, is limited to situations only involving a Member State and a third state thereby excluding situations in which the state where the business activities of an enterprise are carried on (the State of source) and the state where the enterprise is a resident (the State of residence) are EU Member States.

If an aggressive tax planning arrangement would involve more than one mismatch situation the guidance would apply to each mismatch situation separately.

- ***Subparagraph 1.1***

1.1. a *permanent establishment* is treated as *hybrid* where the business activities of an enterprise are:

The meaning of a permanent establishment ("PE") being treated as hybrid is the cornerstone of the guidance.

The pre-condition for the existence of a HPE is that an enterprise resident in one state carries on business activities in another state. The Guidance identifies the following two types of HPE.

1.1.1. not recognised as carried on through a permanent establishment in the state where those activities are carried on (the state of source) but are recognised as carried on through a permanent establishment in the state where the enterprise is a resident (the state of residence), or

The first type of HPE refers to inconsistent treatment of business activities carried on in a state by an enterprise resident in another state.

This definition deals with a situation where the business activities are recognised as carried on through the PE only in the state where the enterprise is a resident.

1.1.2. are recognised as carried on through a permanent establishment in the state where those activities are carried on (the state of source) but are not recognised as carried on through a permanent establishment in the state where the enterprise is a resident (the state of residence), or

The second type of HPE refers to the inconsistent treatment of business activities carried on in a state by an enterprise resident in another state. This definition deals with a situation where the business activities are recognised as carried on through a PE only in the state where those activities are carried on. This can give rise to a double deduction in certain circumstances.

- ***Subparagraph 1.2***

1.2. a *mismatch situation* for a Member State and a third state, in relation to a hybrid permanent establishment, is where the mismatched treatment by the two states of business activities of an enterprise as carried on through the permanent establishment is relevant to the treatment for tax purposes of profits from business activities of the enterprise;

As definitions provided in *subparagraph 1.1.* limit the scope of the guidance to the hybrid nature of the PE, the term “a mismatch situation” serves to determine a condition for *paragraph 2* to apply. The mismatch situation would thus arise where an inconsistent treatment of business activities would lead to the undesirable results defined in *subparagraphs 1.3 and 1.4*.

- ***Subparagraph 1.3***

1.3. *a non-taxation without inclusion* arises where the profits from business activities are not taxed in the state of source as such activities are treated as not being carried on through a permanent establishment, while those profits are exempt from tax in the state of residence as profits attributable to a permanent establishment;

This paragraph defines a specific type of double non-taxation, i.e. *a non-taxation without inclusion* resulting from inconsistent treatment of business activities by two states (the one of residence and the one of source - *Example 1*).

This definition suggests that *non-taxation without inclusion* could only arise where a state of residence of an enterprise eliminates double taxation of profits from business activities carried on in another state by the exemption method.

Employment of the credit method should not exclude any profits from business activities from tax in the state of residence and therefore this type of effect should not arise.

- ***Subparagraph 1.4***

1.4. ***a double deduction arises where a deduction or other tax relief is given in each of two states for the same payment, expense or loss attributed to a hybrid permanent establishment, insofar as that payment, expense or loss is deducted from or relieved against the income that is not attributed to the hybrid permanent establishment*****;**

This paragraph defines another type of double non-taxation, i.e. *a double deduction* resulting from an inconsistent treatment of business activities by two states (the one of residence and the one of source – *Example 2*).

Unlike in the example of double non-taxation set out in subparagraph 1.3, a double deduction can arise if the enterprise's state of residence eliminates double taxation with either the credit or exemption methods. This is because the residence state does not recognize the existence of a PE.

- ***Paragraph 2***

2. Where as a result of a mismatch situation for a Member State and a third state, in relation to a hybrid permanent establishment

2.1. a non-taxation without inclusion would otherwise arise, then, for the purpose of preventing the non-taxation without inclusion,

2.1.1. where the third state treats the business activities concerned as if they were not being carried on through a permanent establishment the Member State concerned should treat the business activities concerned as if they were not being carried on through a permanent establishment,

2.1.2. where the third state treats the business activities concerned as if they were being carried on through a permanent establishment the Member State concerned should treat the business activities concerned as if they were being carried on through a permanent establishment,

or

2.2. a double deduction would otherwise arise, then, for the purpose of preventing the double deduction,

2.2.1. where the third state treats the business activities concerned as if they were not being carried on through a permanent establishment the Member State concerned should treat the business activities concerned as if they were not being carried on through a permanent establishment,

2.2.2. where the third state treats the business activities concerned as if they were being carried on through a permanent establishment the Member State concerned should treat the business activities concerned as if they were being carried on through a permanent establishment,

2.2.3. where the third state treats the business activities concerned as if they were being carried on through a permanent establishment and a double deduction still occurs where the Member State concerned treats the business activities concerned as if they were being carried on through a permanent establishment that MS should remove the double deduction by denying deductions to the company carrying on the business activities that give rise to the mismatch,

notwithstanding the treatment of such activities or amount that would otherwise apply.

Paragraph 2 contains the text that prevents the mismatched treatment of HPE by Member States and third countries from resulting in *non-taxation without inclusion or double deduction*.

To do so, it draws upon the terms set out in *paragraph 1* to identify the elements that must be present for the guidance to apply, i.e.

- a *mismatch situation* involving a Member State and a third state,

- in relation to a *HPE*,

- resulting in *non-taxation without inclusion or double deduction.*

This approach, of prescribing alignments, has been adopted as a clear and straightforward approach to anti-mismatch coordination:

o It provides the clearest basis for the alignment of treatments to eliminate mismatches resulting in non-taxation without inclusion and double deductions - the central purpose of the Guidance.

o It eliminates an administratively problematic scenario that could arise with other approaches.

Where these elements are present, paragraphs 2.1.1 to 2.2.2 prescribe an alignment of the treatments of the hybrid PE, to prevent the mismatch that results in the non-taxation without inclusion or double deduction.

The agreed guidance relating to intra-EU hybrid PE mismatch arrangements covers two specific examples which are set out in annex A to that guidance. Each of these examples involves a mismatch between two Member States, A and B. The guidance removes the mismatch with an "alignment" solution by which the Member States agree to treat the business activities as being carried on through a PE or not.

Extending this guidance to cover mismatches involving third states makes it necessary to include further cases for each example, i.e. the Member State can be either state A or state B and under Example 2 an additional case is added to take into account cases in which despite the alignment the double deduction is not resolved.

Paragraphs 2.1.1 and 2.2.1. are based on the existing intra-EU fixed alignment rules. They work also for those third state situations, in which the Member State can re-characterise the business activities and solve the mismatch.

Paragraphs 2.1.2. and 2.2.2. are introduced as a consequence of the fact that this guidance deals with Member States relations to third states where it cannot be ensured that a single fixed alignment approach can be used to eliminate the mismatch as a third state will not be bound by a guidance agreed by EU Member States.

Paragraph 2.2.3. is introduced as a consequence of the fact that paragraph 2.2.2. will solve the mismatch but may not remove the double deduction if the Member State concerned still takes into account the interest of the PE.

Paragraph 2.1.1.

The paragraph covers the situation of profits made by a hybrid PE that give rise to a non-taxation without inclusion (see example 1). It is possible for the Member State to be either the state where the hybrid PE is not located (state A) or the state where the hybrid PE is located (state B).

If the Member State is state A (see example 1 case 1) then the existing, intra-EU fixed alignment to transparent also works for third states. By not recognising the hybrid permanent establishment State A will have the right to tax the profits arising in State B and State B can continue not to tax the profits attributable to the hybrid PE. As a result the non-taxation without inclusion is solved.

Paragraph 2.1.2.

The paragraph covers the situation of profits made by a hybrid PE that give rise to non-taxation without inclusion (see example 1). It is possible for the Member State to be either the state where the hybrid entity is not located (state A) or the state where the hybrid PE is located (state B).

If the Member State is state B (see example 1 case 2) then it cannot ensure that the profit made by the hybrid PE is taxed unless it recognises it as a PE. In the context of the Subgroup guidance this could be expressed as an alignment to recognition, which has the effect of taxing the profit of the business activities in state B. [10]

Paragraph 2.2.1.

This paragraph covers the situation of payments made by a hybrid PE that give rise to double deduction (see example 2). It is possible for the Member State to be either the state where the hybrid PE is not located (state A) or the state where the hybrid PE is located (state B).

If the Member State is state B (see example 1 case 1) then the existing, intra-EU fixed alignment rule also works for third states. This means treating the business activities concerned as if they were not carried on through a PE. As a result the deduction of the payment cannot be made in state B.

Paragraph 2.2.2.

This paragraph covers the situation of payments made by a hybrid PE that give rise to double deduction (see example 2). It is possible for the Member State to be either the state where the hybrid PE is not located (state A) or the state where the hybrid PE is located (state B).

If the Member State is state A (see example 2 case 2) then it cannot avoid a double deduction unless it recognises the business activities as a PE resulting in a deduction being possible only in state B. In the context of the Subgroup guidance this could be expressed as an alignment to recognition, which has the effect of a deduction being possible only in State B.

Paragraph 2.2.3.

This paragraph covers the situation of payments made by a hybrid PE that give rise to double deduction (see example 2). The Member State is the state where the hybrid PE is not located (state A).

If the Member State is state A (see example 2 case 3) it would align itself to the treatment in state B and recognise the business activity as a PE. This would remove the hybrid mismatch, but it will not necessarily in all cases remove the double deduction. In case the PE makes a profit, relief for the avoidance of double taxation could for instance be granted via the credit method. However, in case the PE incurs a loss, Member State A may take into account this loss as part of its worldwide profits. To remove the double deduction that would then occur, the state would have to deny A Co the deduction. In the context of the Subgroup guidance this could be expressed as an alignment to recognition with an additional rule, which denies a deduction to A Co (the Head office or parent company).

[10] It might be difficult for State B to find out that State A recognises a PE in State B.

In order to underline that the solutions provided for in paragraph 2 will be used only to address harmful effects of mismatch situations, its text has been expressed in fictional form ("as if"). In addition, this wording reconfirms that the guidance shall not interfere with the provisions of double taxation conventions between the source and the residence state. Where the guidance results in taxation not in line with the provisions of a double taxation convention, Member States concerned shall endeavour to solve the issue by mutual agreement.

- ***Paragraph 3***

3. A business activity should be treated as being a PE or not, in accordance with this guidance and contrary to the treatment that would otherwise apply, only to the extent that is necessary for the purpose of preventing a double deduction or non-taxation without inclusion that would otherwise arise – taking into account other rules that neutralise the effects of hybrid mismatches – and not for any other purpose.

Paragraph 3 serves the following purposes:

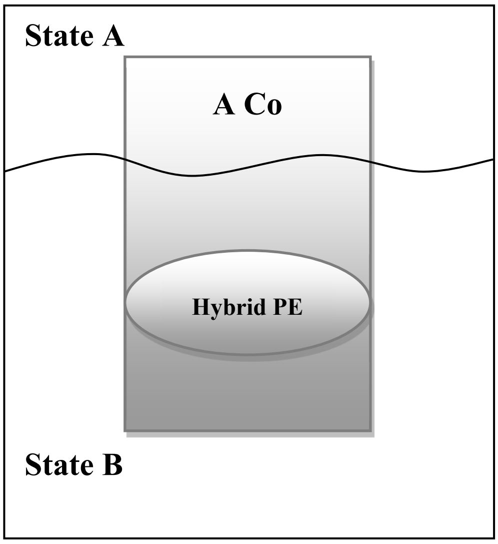
- it is intended to prevent any manipulation or abuse of the proposed guidance. It should also ensure that no more than necessary is done to prevent HPE mismatches delivering *non-taxation without inclusion or double deductions*;

- it clarifies that the guidance is applied only when other means (e.g. national rules) are not sufficient to prevent *non-taxation without inclusion or double deductions*;

- it clarifies that the guidance shall not apply to the extent that it would result in asymmetrical treatment of income and double taxation.

Annex A – Examples

Example 1



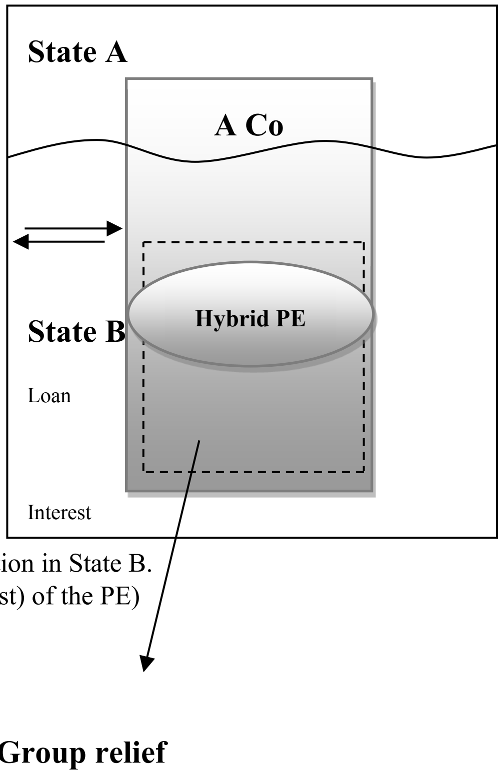
hybrid PE is

- <u>recognised as PE</u> for State A tax purposes;
  State A exempts profits of A Co
  attributable to PE in State B;
- <u>not recognised as PE</u> for State B tax purposes;
  State B does not tax profits
  attributable to PE

non-taxation without inclusion arises

- Scenario 1 (MS = State A)
  If alignment to non-recognition:
  State A and State B do not recognise PE;
  State A taxes profits from activities in state B
- Scenario 2 (MS = State B)
  If alignment to recognition:
  State A and State B recognise PE;
  State B taxes profits from activities in State B

Example 2



hybrid PE is

- <u>not recognised as PE</u> for State A tax purposes;
  It pays interest on a loan;
  The interest is set off by A Co against other income;
- <u>recognised as PE</u> for State B tax purposes;
  The PE as such has no other income in State B;
  The loss (the interest) is offset against B Co's profits
  in MS B.

double deduction arises

- Scenario 1 (MS = State B)
  If alignment to non-recognition:
  State A and State B do not recognise PE;
  State A taxes; single deduction in State A.
- Scenario 2 (MS = State A)
  If alignment to recognition:
  State A and State B recognise PE;
  State A does not take into account the interest paid; single deduction in State B.
- Scenario 3 (MS = State A and taking into account the loss (interest) of the PE)
  If alignment to recognition:
  State A and State B recognise PE;
  State A denies the Head office (A Co) the deduction.