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From:	General Secretariat of the Council
To:	Delegations
Subject:	Guidance of the Code of Conduct Group (Business Taxation) on Hybrid Permanent Establishment Mismatches concerning a Member State and a third state

Delegations will find attached the Guidance of the Code of Conduct Group (Business Taxation) on Hybrid Permanent Establishment Mismatches concerning a Member State and a third state, and the explanatory notes on this Guidance, as endorsed by the Council (ECOFIN) on 17 June 2016.

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.

ANNEX II

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. [1]

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).

[1] 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.

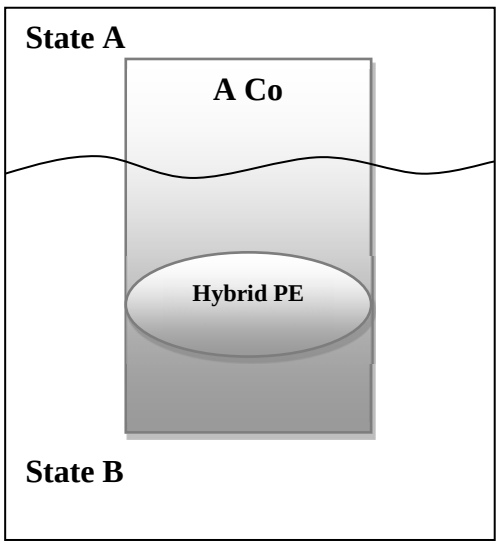
Paragraph 3 serves the following purposes:

- 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.

Example 1



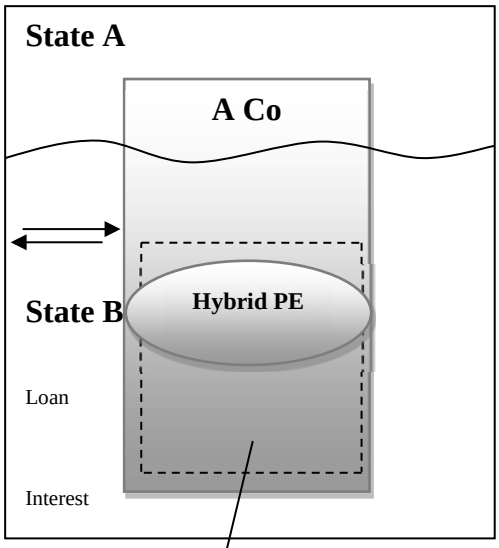
hybrid PE is

- <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.

Group relief