INTERNATIONAL COMITY AFTER THE TAX CUTS AND JOBS ACT OF 2017 (PART TWO)

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Prelude

"Comity" defined

- "A state of civility or courtesy between people, organizations, and nations.
  - It's a hoped-for mutual respect and friendliness, although too infrequently the case in politics and business."
- "A harmonious state of things in general and of their properties (as of colors and sounds); congruity of parts with one another and with the whole."
- "State or atmosphere of harmony or mutual civility and respect."
- *Comity of nations*: "courteous respect by one nation for the laws and institutions of another."
- *"Comity* is one of those rare words that has retained its original meaning through the ages. The Latin adjective *cōmis*, "courteous, friendly," developed into the noun *cōmitātem*, meaning "courtesy or friendliness" and ultimately into English *comity* in the 16th century."
- "The phrase *comity of nations*, coined in 1862, refers to the mutual respect for each other's laws and institutions that encourages a friendly back-and-forth between nations."

What does international tax comity mean?

- All countries have the *exact same rules*?
  - Examples: EU's tax directives; OECD BEPS recommendations.

- Having rules that *fit together*? Fit together *how*?
  - To avoid double-taxation? Examples: OECD Model Treaty, UN Model Treaty.

- Avoiding rules that impose undue burdens on foreign persons.
    - In-bound equity and debt investments
    - Engaging in a U.S. trade or business (directly or thru U.S. subsidiary)
    - When counterparties in transactions with US persons
  - Burdens include complexity, compliance costs, tax costs, risks arising from uncertainty.
- Not engaging in tax competition
  - Sweet-heart deals and rulings for US persons
  - Tax breaks to strengthen U.S. economy (to detriment of other countries' economies)
- Not reneging on our treaty obligations (politely referred to as "treaty overrides").

Comity in Three Acts

- **Act I**: In Which All the Players *Appear* to Sing the Same Song
  - Rules limiting interest expense deductions.

- **Act II**: In Which Our Leading Man Takes a Novel Approach to His Treaty Obligations
  - Overriding Treaty's PE Business Profits Computations?

- **Act III**: In Which All the Players Get Into a Bar Room Brawl
  - Digital tax.

Act I: Singing the Same Song

- Rules Limiting the Deduction of Business Interest
  - Is there an international consensus?
- Developments
  - OECD BEPS Reports – Oct. 2015 (update Dec. 2016).
  - EU ATAD I and ATAD II – July 2016 and May 2017.
  - US TCJA 163(j) - Dec. 2017.
    - Impact of US TCJA 59A (BEAT).

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OECD BEPS Project Action 4: Limiting Base Erosion Involving Interest Deductions

- "BEPS risks in this area may arise in three basic scenarios:
  - Groups placing higher levels of third party debt in high tax countries.
  - Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense.
  - Groups using third party or intragroup financing to fund the generation of tax exempt income."
- Final Report October 2015.
- Updated Final Report December 2016.
  - adds special recommendations for banking/insurance sector.

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OECD BEPS Reports Recommended Rules

- **1. *De minimis* monetary threshold to remove low risk entities.**
  - Optional: based on net interest expense of local group.
- **2. Fixed ratio rule:** entity may deduct net interest expense up to a *benchmark net interest/EBITDA ratio*
  - Relevant factors set out to help a country set its benchmark ratio within a corridor of 10%-30%.
- **3. Optional group ratio rule:** entity may deduct net interest expense up to *its group's net interest/EBITDA ratio (*where this is higher than the benchmarked ratio).
- **4. Optional carry forward of disallowed interest/unused interest capacity and/or carry back of disallowed interest.**
- **5. Targeted rules to support the general rules and address specific risks.**
- **6. Specific rules to address banking and insurance sectors.**

EU Anti-Tax Avoidance Directives ATAD I (July 2016) and ATAD II (May 2017)

- "EU directives should be … **the preferred vehicle for implementing OECD BEPS conclusions** at the EU level."
- "It is essential … that, **as a minimum, Member States implement their commitments under BEPS** and more broadly, take action to discourage tax avoidance practices and ensure fair and effective taxation in the Union in a sufficiently coherent and coordinated fashion."
- "There is a need for common strategic approaches and coordinated action."
- "Only a common framework could prevent a fragmentation of the market and put an end to currently existing mismatches and market distortions."
- "It is necessary to lay down rules…. As these rules would have to fit in 28 separate corporate tax systems, they should be limited to general provisions and leave the implementation to Member States … in a way that fits best their corporate tax systems."

So far, 5 ATAD Directives

- *Interest Limitation Rule* (ATAD Article 4).
  - We will focus on this one.

- Hybrid Mismatches (ATAD Articles 9, 9(a) and 9(b)); *see* BEPS Action 2
- CFC Rule (ATAD Articles 7 & 8); *see* BEPS Action 3
- General Anti-Abuse Rule (ATAD Article 6); *see* BEPS Action 6
- Exit Taxation (ATAD Article 5).

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ATAD: Interest Limitation Basic Rule

- Implementation required by January 1, 2019
  - unless Member State has equally effective existing rules, in which case later of January 1, 2024 and first tax year following publication of OECD minimum standards.
- Basic rule: deduction for "exceeding borrowing costs" ("EBC") limited to 30% (or less) of taxpayer's tax-adjusted EBITDA for the relevant tax period.
  - EBC = net interest expense
    - taxable interest and other economically equivalent revenues *minus* deductible borrowing costs.
  - EBITDA: computed without tax-exempt income.
- Basic rule applies to all interest expense
  - both related-party and third-party debt.
  - creditor's country of tax residence not relevant.
  - no arms-length exception.

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ATAD: Interest Limitation
Optional Variations Available to Member States

- *De minimis* rule (EBC up to €3m fully deductible, computed at the group level).
- EBC fully deductible for a "stand-alone company" (*i.e.*, not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment).
- Carry-forward/carry-back of (i) non-deductible EBC or (ii) excess EBC capacity.
- A taxpayer belonging to a group may fully deduct its EBC if it can demonstrate that its equity/total assets is equal to (≥ 98%) or higher than the equity/total assets of the group.
- A taxpayer belonging to a group may deduct based on its EBC Group Ratio times its EBITDA (rather than 30% times its EBITDA).
  - *EBC Group Ratio* = EBC of the group vis-à-vis third-parties over EBITDA of the group.
- Exclusions for pre-June 2016 loans, and certain public infrastructure financings and other financial undertakings.

US TCJA: New Section 163(j)

- Deduction for business interest expense may not exceed the sum of:
  - business interest income for a taxable year; and
  - 30 percent of "adjusted taxable income" ("ATI") for such taxable year.
- Effectively caps net interest expense deduction to
  - 30% of EBITDA through end of 2021, and then at 30% of EBIT.
- Disallowed business interest carried forward indefinitely; and treated as business interest paid/accrued in the succeeding taxable year subject to 163(j) limitation.
- Unlike Old Section 163(j) no carry forward of "excess" deduction capacity.
- Unlike Old Section 163(j), applies to interest paid to unrelated parties, and applies irrespective of arms-length terms, leverage ratios or other conditions.
- No "out" based on group external leverage ratios.
- Narrow exception for very small taxpayers and certain real estate businesses.
- **Legislative history says *zero* about BEPS Action 4 reports (and ATAD), even though the new 163(j) is fairly consistent with BEPS Action 4 reports.**

New 163(j) Proposed Regulations (Nov. 2018)

- "Interest"
  - Defined broadly to include certain items related to debt instruments, like substitute interest payments under a securities loan, gains and losses from hedges of debt instruments, commitment fees and debt issuance costs.
  - Anti-avoidance rule: any deductible expense or loss "predominantly incurred in consideration of the time value of money" also treated as interest.
- Complex rules for partnerships.
  - First, apply 163(j) limitation at partnership level based on income and expenses of partnership; and
  - Second, any resulting disallowed interest expense then allocated to partners as interest expense subject to 163(j) again at partner level.
- CFCs subject to 163(j) limitation for purposes of computing subpart F income, GILTI tested income or loss, and ECI.
- Complex rules for consolidated groups.

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163(j) Prop Regs: How to compute "ATI" Start with "taxable income", then.....

Some Key Additions:

- business interest expense;
- NOL deduction;
- 199A deduction;
- deduction for capital loss carryback or carryover;
- for years beginning before January 1, 2022:*
  - depreciation under sections 167 or 168;
  - amortization of intangibles under sections 167 or 197;
  - certain other amortized expenditures
  - certain depletion.

* But not if capitalized into inventory

Some Key Subtractions:

- business interest income;
- lesser of: (1) any gain recognized on the sale or other disposition of property; and (2) depreciation, amortization, or depletion for taxable years after December 31, 2017 and before January 1, 2022, with respect to such property;
- certain consolidated return investment adjustments attributable to depreciation, amortization, and depletion on disposition of shares of member of a consolidated group;
- distributive share of certain depreciation, amortization, and depletion allowable under section 704(d) upon the sale or other disposition of a partnership interest.

This is a general summary;
there are many additional special rules.

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163(j) Prop Regs Rules for CFCs

- Single entity (CFC by CFC approach) as general rule.
- Irrevocable "group election" (subject to carve out for financial business sub-groups).
  - Avoids interest paid to another CFC but picked up as income by same shareholder as Subpart F or GILTI being limited.
  - No comparable relief for interest by CFC to U.S. shareholder directly.
- ATI generally excludes related party dividend income but may elect to roll-up lower-tier CFC ATI in excess of interest deduction.

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US TCJA: New 59A Base Erosion Anti-Abuse Tax "BEAT"Overview

- Minimum tax (10% rate 2019- 2025) on large U.S. corporations to curb outbound base eroding payments made to related foreign parties ("RFPs").
  - BEAT minimum rate applies to modified taxable income
  - Meaning, taxable income adding back deductible base eroding payments to RFPs.
- Base eroding payments generally include:
  - Interest, royalties, certain service and reinsurance payments, and some COGS and deductions attributable to depreciable or amortizable assets acquired from RFPs;
  - No "out" even if on demonstrably arms-length terms.
- BEAT applies only to corporations with average receipts of US$500M over 3 years and a "base erosion percentage" of 3% or more.
- No foreign tax credits.
- Anti-abuse rules.

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BEAT – Applicable Taxpayer and Aggregation

- To determine "applicable taxpayer" status, aggregate group concept applies:
  - All corporations that are treated as single employer under section 52(a) are aggregated.
  - Generally means members of "same controlled group of corporations" (defined in section 1563(a) substituting "more than 50%" for "at least 80%").
  - Payments within group generally not included in gross receipts or numerator/denominator of "base erosion percentage" calculation.
  - Foreign corporations taken into account only to extent of their ECI (or treaty business profits).

Base Erosion Percentage Test

- BEAT generally applies if base erosion percentage equals or exceeds 3%
- Lower 2% threshold if affiliated group includes domestic bank or registered securities dealer
- Base erosion percentage = $\frac{\text{aggregate amount of "base erosion tax benefits"}}{\text{aggregate amount of deductions + certain other base erosion tax benefits}}$
- Base erosion tax benefits generally are deductions or reduction in gross income resulting from "base erosion payments".
- Percentage is calculated as of end of taxpayer's taxable year-- group members with different taxable years can have different base erosion percentages (i.e. fiscal and calendar year taxpayers that are members of the same aggregate group highly likely to have different base erosion percentages).

Base Erosion Payments Defined

- Payment or accrual by taxpayer to RFP:
  - if deductible (e.g., royalties, interest, payments for services);
  - if connected to acquisition of depreciable/amortizable property;
  - if reinsurance premiums or other consideration for reinsurance;
  - if involves certain surrogate foreign corporations or related foreign persons, then payments that reduce cost of goods sold
- RFP includes
  - 25% owner of taxpayer (by vote or value);
  - Persons related to taxpayer or 25% owner (within the meaning of section 267(b) or 707(b)(1)); and
  - Controlled taxpayer within the meaning of section 1.482-1(i)(5) together with, or with respect to, the taxpayer.
- Not a Base Erosion Payment if recipient subject to U.S. net income tax (as ECI or PE business profits)

Base Erosion Tax Benefits Defined

- Generally, amount of deduction (or reduction of gross income) relating to base erosion payment allowed under Code for taxable year.
- If withholding tax imposed, no base erosion benefit if full 30% withheld.
  - If lower treaty rate applicable, exclusion is reduced proportionately to withholding tax exemption.
- If section 163(j) applies, all disallowed business interest treated first as interest paid/accrued to unrelated party then to related party.
- Allowed portion of business interest expenses paid/accrued to both unrelated and related party is allocated pro rata between domestic and foreign related parties, then to unrelated parties.

Modified Taxable Income Defined

- Modified Taxable Income: taxable income computed under chapter 1 without regard to base erosion tax benefits and base erosion percentage of any NOL deduction for the taxable year.
- Determined on taxpayer-by-taxpayer basis.
- Uses add-back approach:
    - Start with taxable income/loss and add back gross amount of base erosion tax benefits and base erosion percentage of NOL deduction.
    - Simplification, avoids parallel attribute system of old AMT.
- Base erosion percentage of NOL deduction fixed on vintage year base (i.e. base erosion percentage in year in which NOL arose).
- For NOLs arising before 2018, base erosion percentage is zero.

Act II: Treaty Obligations

- TCJA Proposed Regulations that appear to override US Treaty's PE "business profits"
    - The relevant treaty provision: computation of taxable profits of a PE (using AOA).
    - 2 TCJA overrides: via Proposed Regulations under 59A and 267A.

AOA for computing business profits of a PE under a treaty

- In 2008, OECD issued a report on "Attribution of Profits to Permanent Establishments".
- The OECD approach has become known as the AOA (Authorized OECD Approach ("AOA") to computing business profits of a PE branch.
  - Treats PE as if it were a separate entity from the home office (a related separate entity) and applies standard transfer pricing rules.
  - Determines the profits the PE "might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through the other parts of the enterprise."

US Model Treaty Feb 2016: Article 7 "Business Profits"

- 1. Profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 of this Article may be taxed in that other Contracting State.
- 2. For the purposes of this Article, the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 of this Article are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.
- 3. Where, in accordance with paragraph 2 of this Article, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other Contracting State, the other Contracting State shall, to the extent necessary to eliminate double taxation, make an appropriate adjustment if it agrees with the adjustment made by the first-mentioned Contracting State; if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement.

Prog. Regs. 1.59A-3(b)(4)(v)(B): "internal dealings" rule: applies 59A to a PE's AOA deductions

- "If, pursuant to the terms of an applicable income tax treaty, a foreign corporation determines the profits attributable to a PE based on the assets used, risks assumed, and functions performed by the permanent establishment, then any deduction attributable to any amount paid or accrued (or treated as paid or accrued) by the PE to the foreign corporation's home office or to another branch of the foreign corporation (an 'internal dealing') is a base erosion payment to the extent such payment or accrual is" a 'base erosion payment' described under in Prop. Regs. 1.59A-3(b)(1)."
- "Base erosion payments" include: "any amount paid or accrued by the taxpayer to a foreign related party of the taxpayer and with respect to which a deduction is allowable".

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Prop. Reg. 1.267A-2(c)(2): "deemed branch payments" rule

- Applies a super-charged 267A to a PE's AOA interest and royalty deductions.
- "deemed branch payment" =
  - AOA fictional deduction for interest or royalty *as if* the PE were paying interest/royalty to the foreign corporation home office, and
  - no inclusion to foreign corporation under its foreign country tax rules.
- Deemed branch payment rule = the interest/royalty deduction is disallowed in computing the PE's business profits (i.e., *overrides* treaty).
- Theory of the rule:
  - if branch were a separate entity subsidiary that made an actual payment that was not included by the foreign corporation, then 267A disallowance would apply; and
  - rules should treat branches the same as separate entity subsidiaries.
- <u>*NB:*</u> the normal 267A rule would disallow the deduction ***only*** if the non-inclusion was the result of the payment being interest or royalty (i.e., if payment were something else, it would be included) ***but*** the deemed branch payment rule disallows the deduction solely because there is a non-inclusion.

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Commentary

- Treaty overrides are permitted under US law <u>**but**</u>
- Reactions to Prop 59A "internal dealings" rule and Prop 267A "deemed branch payments" rule was very negative
  - 59A: a lot of commentators weighed;
  - 267A: two commentators weighed in.
  - *"Inconsistent with treaty obligations and with theory of AOA" which is supposed to determine the appropriate amount of profits of PE for US to tax.*
  - *How can US increase that amount without violating its commitment under the treaty?*
- How bad is it? Is it not even bad at all?

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Consider this from OECD's report on AOA

- "The AOA does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE. … In addition, the AOA is not designed to prevent the application of any domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of assets or risks. Finally, where their domestic law does not recognise loss transactions in certain circumstances between associated enterprises, countries may consider that the AOA would not require the recognition of a loss on an analogous dealing in determining the profits of a PE."

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FWIW also consider this *from the Feb 2016 US Model Treaty Preamble*

- "The 2016 Model has not adopted the other BEPS recommendations regarding the permanent establishment threshold, notably the revised rules related to dependent and independent agents and the exemption for preparatory and auxiliary activities.
- "It is important to ensure that the implications from any modifications to these treaty provisions are commonly understood and consistently administered by treaty partners.
- "Accordingly, the Treasury Department is working with OECD and G20 member countries to create a common global understanding regarding profit attribution that will address the concerns raised by these BEPS permanent establishment recommendations."

Act III: Bar Room Brawl Over Digital Tax

- Our Players in this Act include
  - OECD: trying to develop global consensus proposal; due 2020.
  - EU: Directive on Common System of Digital Services Taxes (2018).
  - UK: Proposed Digital Services Tax (2018).
  - France: Proposed Digital Services Tax (2019).
  - Italy: Tax on Digital Services (2018).
  - US: FDII and GILTI (2018).
  - Various others without title credits.

OECD Activities on Digital

- OECD (2015), *Addressing the Tax Challenges of the Digital Economy*, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project.
- OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018*, Inclusive Framework on BEPS.
  - Response: over 200 comment letters.
- OECD (Feb. 2019), *Addressing the Tax Challenges of the Digitalisation of the Economy,* Public Consultation Document

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OECD: Feb 2019 Consultation Document

- "One of the important conclusions of [the 2018 Report] is that members agreed to review the impact of digitalisation on nexus and profit allocation rules and committed to continue working together towards a final report in 2020 aimed at providing a consensus-based long-term solution, with an update in 2019."
- "Since the delivery of the Interim Report, the Inclusive Framework further intensified its work and several proposals emerged that could form part of a long-term solution to the broader challenges arising from the digitalisation of the economy and the remaining BEPS issues. … In this context, the Inclusive Framework agreed to hold a public consultation on possible solutions to the tax challenges arising from the digitalisation of the economy on 13 and 14 March 2019 at the OECD Conference Centre in Paris, France."
- "The objective is to provide external stakeholders an opportunity to provide input early in the process and to benefit from that input. As part of this public consultation, this consultation document describes the proposals discussed by the Inclusive Framework at a high level and seeks comments from the public on a number of policy issues and technical aspects. The comments provided will assist members of the Inclusive Framework in the development of a solution for its final report to the G20 in 2020."

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OECD Officials Prior to Public Consultation

- "OECD head of tax policy Pascal Saint-Amans said there was a change of tone judging from more than 200 comments the Paris-based policy forum received in a first call for input from businesses, accounting firms, tax justice NGOs and academics."
- "'We have a significant group of business people saying it's probably time to do something,' Saint-Amans told Reuters."
- "While opposed to unilateral national taxes, Washington is a relatively recent convert in favor of a wide-ranging international overhaul, although it wants a solution with a broader focus than just digital companies."
- "'Bargain will have to be made and ... the more extreme proposals will not attract consensus,' the U.S. Treasury's top international tax official, Chip Harter, told journalists."
- "He added that the aim was to have the broad outlines of an agreement from the OECD in June, so that G20 finance ministers could give a mandate to thrash out the numerous technical details before a formal deal is signed in 2020."
  - Reuters, March 12, 2019 by Leigh Thomas.

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U.S. Reaction to French and UK Digital Tax Developments (May 20, 2019)

- "Treasury officials have been engaged in 'vigorous diplomacy' to dissuade governments from enacting unilateral measures — especially digital services taxes — while countries are in the middle of negotiations on a global consensus-based solution."
- "According to Lafayette G. "Chip" Harter III, Treasury deputy assistant secretary for international tax affairs, unilateral measures proposed or adopted in Europe and elsewhere threaten to undermine negotiations among members of the OECD's base erosion and profit-shifting project's inclusive framework. Speaking May 10 in Washington at the American Bar Association Section of Taxation meeting, Harter said DSTs — which apply to gross turnover for a narrow range of digital transactions — are especially problematic".
- '**"Of greatest concern at the moment are the proposed digital services taxes, one working its way through the French legislative process and the U.K. proposed digital services tax, which would start next year. We've been arguing very strongly that any such taxes should be deferred until after 2020 to give the OECD a chance to agree on an alternative,' Harter said. 'We will keep making the point that digital services taxes are just a very bad idea from a policy standpoint.'"**
- "Harter criticized DSTs for taxing gross revenue instead of economic profit, targeting an innovative sector of the economy, and having design features that ensure they disproportionately target U.S. companies. **He added that the common practice of referring to DSTs as 'GAFA taxes' — referring to Google, Amazon, Facebook, and Apple— clearly shows that U.S. companies are the intended target."**
  - **Tax Notes by Ryan Finley**

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More US Reaction to French Proposal (March 13, 2019)

- "The proposed 3 percent tax on digital activities appears to be 'highly discriminatory' to U.S. firms, Lafayette G. "Chip" Harter, deputy assistant secretary for international tax affairs at the Treasury Department's Office of Tax Policy, said March 12 at an event in Paris. He said Treasury, the U.S. Trade Representative's office, and lawmakers are 'studying whether the discriminatory impact would give us rights under trade agreements, WTO, treaties.'"
- "But if the French tax does go into effect, it could lead to a tax treaty dispute, a World Trade Organization challenge, retaliatory tariffs, or the U.S. invoking a never-used section of the tax code to raise taxes on French companies' U.S. subsidiaries."
- **"'You're seeing an appropriate American response to something that is clearly designed to be discriminatory against U.S. companies,' said Jake Colvin, vice president for global trade issues at the National Foreign Trade Council."**
- **"'I think a WTO case in inevitable,'** if France does pass the law and the U.S. responds, said William Alan Reinsch, senior adviser and Scholl Chair in International Business at the Center for Strategic and International Studies. '**You always do that, even if it's not the only thing you do.'"**

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French Response (April 8, 2019)

- "A French lawmaker involved in drafting the country's digital tax bill **dismissed concerns that the proposal could lead to a trade war with the U.S."**
- **"Our response is two-fold. First, France is a sovereign country that conducts its own tax policy. Second, I don't see how a trade war could be started by a tax that raises 400 million euros," assembly member Joel Giraud said April 8 as the country's National Assembly began debate on the measure."**
- "Secretary of State Mike Pompeo has urged France not to move forward with the proposal, which is aimed at U.S. tech giants like Alphabet Inc.'s Google, Facebook Inc., and Apple Inc."
- "Giraud compared the proposal to **recent European Commission fines on companies like Google** that totaled billions of euros. "**That didn't trigger the apocalypse," he said."**
- "The measure is necessary because France doesn't collect tax on the value U.S. tech multinationals create from French consumer data, said French Finance Minister Bruno Le Maire, also speaking at the National Assembly. **"It is unacceptable that this tax situation leads to the emergence of digital giants that buy, one by one, all our startups and kill innovation in our country," Le Maire said."**
- "France's planned tax has elicited recent responses from other U.S. officials. A group of House Republicans wrote a letter to President Donald Trump urging him to take action in response, and the U.S. Trade Representative's office included digital tax measures like France's on a list of "key barriers to digital trade" in 2019."

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EU Officials Respond (May 20, 2019)

- "EU Tax Commissioner Pierre Moscovici underscored the importance of updating corporate tax rules for the 21st century so that they are based not only on physical presence, but also on digital presence."
- "'But we need now to work on it at the global level,' Moscovici said, pointing to the EU's participation in discussions at the OECD and at the G-20 to find consensus by 2020 on a long term approach to taxing the digital economy."
- "EU Research, Science, and Innovation Commissioner Carlos Moedas agreed on the need for a global solution to avoid unilateral action."
- "However, Moscovici defended EU-wide efforts to introduce a digital services tax, saying that he did not want the proposal to appear protectionist. '**The problem is global and the best level to address it is global, but we also can have a regional answer,' he said**."
  - Tax Notes by Stephanie Soong Johnston

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TCJA's Contribution to the Brawl "The US Counterpunch to the OECD BEPS Project"

- "A prominent agenda item of the OECD BEPS project is the taxation of digital companies. Many countries in the European Union have expressed frustration with the fact that tech companies, such as Apple, Google ,Facebook and Amazon, are able to operate and sell within their jurisdictions, but pay little or no corporate income tax. The US tax reform effort has put in place a provision that would provide US multinationals a lower tax rate on 'intangible income' – in reality, high profits not tied to tangible forms of capital – earned from foreign sources [(FDII)]."
- "If this works effectively, digital companies should find it in their interest to move, not just their profits to the US, but their intellectual property as well. In addition, the TCJA now imposes a minimum tax on excess foreign earnings of US multinationals. **Hence, if the aim of the BEPS project was to capture more of this intangible income in the European Union, the new US tax law will likely interfere with their efforts**."
  - By Aparna Mathur, Resident Scholar in Economic Policy Studies, American Enterprise Institute (2018)

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*Meanwhile, back in DC (*May 22, 2019)

VAN HOLLEN, KLOBUCHAR, DUCKWORTH INTRODUCE LEGISLATION TO KEEP JOBS IN THE UNITED STATES

- "Instituting a "per-country" minimum tax instead of a blended or "global rate" under current law and eliminating companies' ability to deduct 10 percent of their return on tangible assets before the tax rate on foreign income applies. **These changes would remove the incentive for companies to shift U.S. jobs and physical operations overseas (to countries with tax rates similar to the U.S.)** in order to preserve the value of using tax havens."

I

(Legislative acts)

DIRECTIVES

COUNCIL DIRECTIVE (EU) 2017/952

of 29 May 2017

amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 115 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Parliament [1],

Having regard to the opinion of the European Economic and Social Committee [2],

Acting in accordance with a special legislative procedure,

Whereas:

(1) It is imperative to restore trust in the fairness of tax systems and allow governments to effectively exercise their tax sovereignty. Therefore, the Organisation for Economic Cooperation and Development (OECD) has issued concrete action recommendations in the context of the initiative against Base Erosion and Profit Shifting (BEPS).

(2) The final reports on the 15 OECD Action Items against BEPS were released to the public on 5 October 2015. This output was welcomed by the Council in its conclusions of 8 December 2015. The Council conclusions stressed the need to find common, yet flexible, solutions at Union level consistent with OECD BEPS conclusions.

(3) In response to the need for fairer taxation and, in particular, to follow up on the OECD BEPS conclusions, the Commission presented its Anti-Tax Avoidance Package on 28 January 2016. Council Directive (EU) 2016/1164 [3], concerning rules against tax avoidance, was adopted in the framework of that package.

(4) Directive (EU) 2016/1164 provides for a framework to tackle hybrid mismatches.

(5) It is necessary to establish rules that neutralise hybrid mismatches in as comprehensive a manner as possible. Considering that Directive (EU) 2016/1164 only covers hybrid mismatches that arise in the interaction between

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[1] Opinion of 27 April 2017 (not yet published in the Official Journal).
[2] Opinion of 14 December 2016 (not yet published in the Official Journal).
[3] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (OJ L 193, 19.7.2016, p. 1).

the corporate tax systems of Member States, the ECOFIN Council issued a statement on 12 July 2016 requesting the Commission to put forward by October 2016 a proposal on hybrid mismatches involving third countries in order to provide for rules consistent with and no less effective than the rules recommended by the OECD report on Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 — 2015 Final Report ('OECD BEPS report on Action 2'), with a view to reaching an agreement by the end of 2016.

(6) Directive (EU) 2016/1164 recognises, inter alia, that it is critical for further work to be undertaken on other hybrid mismatches such as those involving permanent establishments. In view of that, it is essential that hybrid permanent establishment mismatches be addressed in that Directive as well.

(7) In order to provide for a framework that is consistent with and no less effective than the OECD BEPS report on Action 2, it is essential that Directive (EU) 2016/1164 also include rules on hybrid transfers, imported mismatches and address the full range of double deduction outcomes, in order to prevent taxpayers from exploiting remaining loopholes.

(8) Directive (EU) 2016/1164 includes rules on hybrid mismatches between Member States and should thus also include rules on hybrid mismatches with third countries where at least one of the parties involved is a corporate taxpayer or, in the case of reverse hybrids, an entity in a Member State, as well as rules on imported mismatches. Consequently, the rules on hybrid mismatches and tax residency mismatches should apply to all taxpayers that are subject to corporate tax in a Member State including to permanent establishments, or to arrangements treated as permanent establishments, of entities resident in third countries. Rules on reverse hybrid mismatches should apply to all entities that are treated as transparent for tax purposes by a Member State.

(9) Rules on hybrid mismatches should address mismatch situations which result from double deductions, from conflict in the characterisation of financial instruments, payments and entities, or from the allocation of payments. Since hybrid mismatches could lead to a double deduction or to a deduction without inclusion, it is necessary to lay down rules whereby the Member State concerned either denies the deduction of a payment, expenses or losses or requires the taxpayer to include the payment in its taxable income, as appropriate. However, those rules apply only to deductible payments and should not affect the general features of a tax system, whether it is a classical or an imputation system.

(10) Hybrid permanent establishment mismatches occur where differences between the rules in the jurisdictions of permanent establishment and of residence for allocating income and expenditure between different parts of the same entity give rise to a mismatch in tax outcomes and include those cases where a mismatch outcome arises due to the fact that a permanent establishment is disregarded under the laws of the branch jurisdiction. Those mismatch outcomes may lead to a double deduction or a deduction without inclusion, and should therefore be eliminated. In the case of disregarded permanent establishments, the Member State in which the taxpayer is a resident should include the income that would otherwise be attributed to the permanent establishment.

(11) Any adjustments that are required to be made under this Directive should in principle not affect the allocation of taxing rights between jurisdictions laid down under a double taxation treaty.

(12) In order to ensure proportionality, it is necessary to address only the cases where there is a substantial risk of avoiding taxation through the use of hybrid mismatches. It is therefore appropriate to cover hybrid mismatches that arise between the head office and permanent establishment or between two or more permanent establishments of the same entity, hybrid mismatches that arise between the taxpayer and its associated enterprises or between associated enterprises, and those resulting from a structured arrangement involving a taxpayer.

(13) Mismatches that, in particular, result from the hybrid nature of entities should be addressed only where one of the associated enterprises has, at a minimum, effective control over the other associated enterprises. Consequently, in those cases, it should be required that an associated enterprise be held by, or hold, the taxpayer or another associated enterprise through a participation in terms of voting rights, capital ownership or entitlement to received profits of 50 per cent or more. The ownership, or rights of persons who are acting together, should be aggregated for the purposes of applying this requirement.

(14) In order to provide for a sufficiently comprehensive definition of 'associated enterprise' for the purposes of the rules on hybrid mismatches, that definition should also comprise an entity that is part of the same consolidated group for accounting purposes, an enterprise in which the taxpayer has a significant influence in the management and, conversely, an enterprise that has a significant influence in the management of the taxpayer.

(15) It is necessary to address four categories of hybrid mismatches: first, hybrid mismatches that result from payments under a financial instrument; second, hybrid mismatches that are the consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment, including as a result of payments to a disregarded permanent establishment; third, hybrid mismatches that result from payments made by a hybrid entity to its owner, or deemed payments between the head office and permanent establishment or between two or more permanent establishments; lastly, double deduction outcomes resulting from payments made by a hybrid entity or permanent establishment.

(16) In respect of payments under a financial instrument, a hybrid mismatch could arise where the deduction without inclusion outcome is attributable to the differences in the characterisation of the instrument or the payments made under it. If the character of the payment qualifies it for double tax relief under the laws of the payee jurisdiction, such as an exemption from tax, a reduction in the rate of tax or any credit or refund of tax, the payment should be treated as giving rise to a hybrid mismatch to the extent of the resulting undertaxed amount. A payment under a financial instrument should not, however, be treated as giving rise to a hybrid mismatch where the tax relief granted in the payee jurisdiction is solely due to the tax status of the payee or the fact that the instrument is held subject to the terms of a special regime.

(17) In order to avoid unintended outcomes in the interaction between the hybrid financial instrument rule and the loss-absorbing capacity requirements imposed on banks, and without prejudice to State aid rules, Member States should be able to exclude from the scope of this Directive intra-group instruments that have been issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements and not for the purposes of avoiding tax.

(18) In respect of payments made to a hybrid entity or permanent establishment, a hybrid mismatch could arise where the deduction without inclusion outcome results from differences in the rules governing the allocation of that payment between the hybrid entity and its owner in the case of a payment that is made to a hybrid entity, between the head office and permanent establishment, or between two or more permanent establishments in the case of a deemed payment to a permanent establishment. The definition of hybrid mismatch should only apply where the mismatch outcome is a result of differences in the rules governing the allocation of payments under the laws of the two jurisdictions and a payment should not give rise to a hybrid mismatch that would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.

(19) The definition of hybrid mismatch should also capture deduction without inclusion outcomes that are the result of payments made to a disregarded permanent establishment. A disregarded permanent establishment is any arrangement that is treated as giving rise to a permanent establishment under the laws of the head office jurisdiction but which is not treated as a permanent establishment under the laws of the other jurisdiction. The hybrid mismatch rule should not apply, however, where the mismatch would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.

(20) In respect of payments made by a hybrid entity to its owner, or deemed payments made between the head office and permanent establishment or between two or more permanent establishments, a hybrid mismatch could arise where the deduction without inclusion outcome results from the payment or deemed payment not being recognised in the payee jurisdiction. In that case, where the mismatch outcome is a consequence of the non-allocation of the payment or deemed payment, the payee jurisdiction is the jurisdiction where the payment or deemed payment is treated as being received under the laws of the payer jurisdiction. As with other hybrid entities and branch mismatches that give rise to deduction without inclusion outcomes, no hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction. In respect of this

category of hybrid mismatches, however, a mismatch outcome would only arise to the extent that the payer jurisdiction allows the deduction in respect of the payment or deemed payment to be set off against an amount that is not dual-inclusion income. If the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, then the requirement to make any adjustment under this Directive could be deferred until such time as the deduction is actually set off against non-dual-inclusion income in the payer jurisdiction.

(21) The hybrid mismatch definition should also capture double deduction outcomes regardless of whether they arise as a result of payments, expenses that are not treated as payments under domestic law or as a result of amortisation or depreciation losses. As with deemed payments and payments made by a hybrid entity that are disregarded by the payee, a hybrid mismatch should only arise, however, to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income. This means that if the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, the requirement to make an adjustment under this Directive could be deferred until such time as the deduction is actually set off against non-dual-inclusion income in the payer jurisdiction.

(22) Differences in tax outcomes that are solely attributable to differences in the value ascribed to a payment, including through the application of transfer pricing, should not fall within the scope of a hybrid mismatch. Furthermore, as jurisdictions use different tax periods and have different rules for recognising when items of income or expenditure have been derived or incurred, those timing differences should not generally be treated as giving rise to mismatches in tax outcomes. However, a deductible payment under a financial instrument that cannot reasonably be expected to be included in income within a reasonable period of time should be treated as giving rise to a hybrid mismatch if that deduction without inclusion outcome is attributable to differences in the characterisation of the financial instrument or payments made under it. It should be understood that a mismatch outcome could arise if a payment made under a financial instrument is not included in income within a reasonable period of time. Such a payment should be treated as included in income within a reasonable period of time, if included by the payee within 12 months of the end of the payer's tax period or as determined under the arm's length principle. Member States could require that a payment be included within a fixed period of time in order to avoid giving rise to a mismatch outcome and secure tax control.

(23) Hybrid transfers could give rise to a difference in tax treatment if, as a result of an arrangement to transfer a financial instrument, the underlying return on that instrument was treated as derived by more than one of the parties to the arrangement. In those cases, the payment under the hybrid transfer could give rise to a deduction for the payer while being treated as a return on the underlying instrument by the payee. This difference in tax treatment could lead to a deduction without inclusion outcome or to the generation of a surplus tax credit for the tax withheld at source on the underlying instrument. Such mismatches should therefore be eliminated. In the case of a deduction without inclusion, the same rules should apply as for neutralising mismatches from payments under a hybrid financial instrument. In the case of hybrid transfers that have been structured to produce surplus tax credits, the Member State concerned should prevent the payer from using the surplus credit to obtain a tax advantage including through the application of a general anti-abuse rule consistent with Article 6 of Directive (EU) 2016/1164.

(24) It is necessary to provide for a rule that allows Member States to tackle discrepancies in the transposition and implementation of this Directive resulting in a hybrid mismatch despite the fact that Member States act in compliance with this Directive. Where such a situation arises and the primary rule provided for in this Directive does not apply, a secondary rule should apply. Nevertheless, the application of both the primary and secondary rules only apply to hybrid mismatches as defined by this Directive and should not affect the general features of the tax system of a Member State.

(25) Imported mismatches shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralise hybrid mismatches. A deductible payment in a Member State can be used to fund expenditure involving a hybrid mismatch. To counter such imported mismatches, it is necessary to include rules that disallow the deduction of a payment if the corresponding income from that payment is set off, directly or indirectly, against a deduction that arises under a hybrid mismatch giving rise to a double deduction or a deduction without inclusion between third countries.

I

(Legislative acts)

DIRECTIVES

COUNCIL DIRECTIVE (EU) 2017/952
of 29 May 2017
amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 115 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Parliament [1],

Having regard to the opinion of the European Economic and Social Committee [2],

Acting in accordance with a special legislative procedure,

Whereas:

(1) It is imperative to restore trust in the fairness of tax systems and allow governments to effectively exercise their tax sovereignty. Therefore, the Organisation for Economic Cooperation and Development (OECD) has issued concrete action recommendations in the context of the initiative against Base Erosion and Profit Shifting (BEPS).

(2) The final reports on the 15 OECD Action Items against BEPS were released to the public on 5 October 2015. This output was welcomed by the Council in its conclusions of 8 December 2015. The Council conclusions stressed the need to find common, yet flexible, solutions at Union level consistent with OECD BEPS conclusions.

(3) In response to the need for fairer taxation and, in particular, to follow up on the OECD BEPS conclusions, the Commission presented its Anti-Tax Avoidance Package on 28 January 2016. Council Directive (EU) 2016/1164 [3], concerning rules against tax avoidance, was adopted in the framework of that package.

(4) Directive (EU) 2016/1164 provides for a framework to tackle hybrid mismatches.

(5) It is necessary to establish rules that neutralise hybrid mismatches in as comprehensive a manner as possible. Considering that Directive (EU) 2016/1164 only covers hybrid mismatches that arise in the interaction between

(1) Opinion of 27 April 2017 (not yet published in the Official Journal).
(2) Opinion of 14 December 2016 (not yet published in the Official Journal).
(3) Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (OJ L 193, 19.7.2016, p. 1).

the corporate tax systems of Member States, the ECOFIN Council issued a statement on 12 July 2016 requesting the Commission to put forward by October 2016 a proposal on hybrid mismatches involving third countries in order to provide for rules consistent with and no less effective than the rules recommended by the OECD report on Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 — 2015 Final Report ('OECD BEPS report on Action 2'), with a view to reaching an agreement by the end of 2016.

(6) Directive (EU) 2016/1164 recognises, inter alia, that it is critical for further work to be undertaken on other hybrid mismatches such as those involving permanent establishments. In view of that, it is essential that hybrid permanent establishment mismatches be addressed in that Directive as well.

(7) In order to provide for a framework that is consistent with and no less effective than the OECD BEPS report on Action 2, it is essential that Directive (EU) 2016/1164 also include rules on hybrid transfers, imported mismatches and address the full range of double deduction outcomes, in order to prevent taxpayers from exploiting remaining loopholes.

(8) Directive (EU) 2016/1164 includes rules on hybrid mismatches between Member States and should thus also include rules on hybrid mismatches with third countries where at least one of the parties involved is a corporate taxpayer or, in the case of reverse hybrids, an entity in a Member State, as well as rules on imported mismatches. Consequently, the rules on hybrid mismatches and tax residency mismatches should apply to all taxpayers that are subject to corporate tax in a Member State including to permanent establishments, or to arrangements treated as permanent establishments, of entities resident in third countries. Rules on reverse hybrid mismatches should apply to all entities that are treated as transparent for tax purposes by a Member State.

(9) Rules on hybrid mismatches should address mismatch situations which result from double deductions, from conflict in the characterisation of financial instruments, payments and entities, or from the allocation of payments. Since hybrid mismatches could lead to a double deduction or to a deduction without inclusion, it is necessary to lay down rules whereby the Member State concerned either denies the deduction of a payment, expenses or losses or requires the taxpayer to include the payment in its taxable income, as appropriate. However, those rules apply only to deductible payments and should not affect the general features of a tax system, whether it is a classical or an imputation system.

(10) Hybrid permanent establishment mismatches occur where differences between the rules in the jurisdictions of permanent establishment and of residence for allocating income and expenditure between different parts of the same entity give rise to a mismatch in tax outcomes and include those cases where a mismatch outcome arises due to the fact that a permanent establishment is disregarded under the laws of the branch jurisdiction. Those mismatch outcomes may lead to a double deduction or a deduction without inclusion, and should therefore be eliminated. In the case of disregarded permanent establishments, the Member State in which the taxpayer is a resident should include the income that would otherwise be attributed to the permanent establishment.

(11) Any adjustments that are required to be made under this Directive should in principle not affect the allocation of taxing rights between jurisdictions laid down under a double taxation treaty.

(12) In order to ensure proportionality, it is necessary to address only the cases where there is a substantial risk of avoiding taxation through the use of hybrid mismatches. It is therefore appropriate to cover hybrid mismatches that arise between the head office and permanent establishment or between two or more permanent establishments of the same entity, hybrid mismatches that arise between the taxpayer and its associated enterprises or between associated enterprises, and those resulting from a structured arrangement involving a taxpayer.

(13) Mismatches that, in particular, result from the hybrid nature of entities should be addressed only where one of the associated enterprises has, at a minimum, effective control over the other associated enterprises. Consequently, in those cases, it should be required that an associated enterprise be held by, or hold, the taxpayer or another associated enterprise through a participation in terms of voting rights, capital ownership or entitlement to received profits of 50 per cent or more. The ownership, or rights of persons who are acting together, should be aggregated for the purposes of applying this requirement.

(14) In order to provide for a sufficiently comprehensive definition of 'associated enterprise' for the purposes of the rules on hybrid mismatches, that definition should also comprise an entity that is part of the same consolidated group for accounting purposes, an enterprise in which the taxpayer has a significant influence in the management and, conversely, an enterprise that has a significant influence in the management of the taxpayer.

(15) It is necessary to address four categories of hybrid mismatches: first, hybrid mismatches that result from payments under a financial instrument; second, hybrid mismatches that are the consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment, including as a result of payments to a disregarded permanent establishment; third, hybrid mismatches that result from payments made by a hybrid entity to its owner, or deemed payments between the head office and permanent establishment or between two or more permanent establishments; lastly, double deduction outcomes resulting from payments made by a hybrid entity or permanent establishment.

(16) In respect of payments under a financial instrument, a hybrid mismatch could arise where the deduction without inclusion outcome is attributable to the differences in the characterisation of the instrument or the payments made under it. If the character of the payment qualifies it for double tax relief under the laws of the payee jurisdiction, such as an exemption from tax, a reduction in the rate of tax or any credit or refund of tax, the payment should be treated as giving rise to a hybrid mismatch to the extent of the resulting undertaxed amount. A payment under a financial instrument should not, however, be treated as giving rise to a hybrid mismatch where the tax relief granted in the payee jurisdiction is solely due to the tax status of the payee or the fact that the instrument is held subject to the terms of a special regime.

(17) In order to avoid unintended outcomes in the interaction between the hybrid financial instrument rule and the loss-absorbing capacity requirements imposed on banks, and without prejudice to State aid rules, Member States should be able to exclude from the scope of this Directive intra-group instruments that have been issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements and not for the purposes of avoiding tax.

(18) In respect of payments made to a hybrid entity or permanent establishment, a hybrid mismatch could arise where the deduction without inclusion outcome results from differences in the rules governing the allocation of that payment between the hybrid entity and its owner in the case of a payment that is made to a hybrid entity, between the head office and permanent establishment, or between two or more permanent establishments in the case of a deemed payment to a permanent establishment. The definition of hybrid mismatch should only apply where the mismatch outcome is a result of differences in the rules governing the allocation of payments under the laws of the two jurisdictions and a payment should not give rise to a hybrid mismatch that would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.

(19) The definition of hybrid mismatch should also capture deduction without inclusion outcomes that are the result of payments made to a disregarded permanent establishment. A disregarded permanent establishment is any arrangement that is treated as giving rise to a permanent establishment under the laws of the head office jurisdiction but which is not treated as a permanent establishment under the laws of the other jurisdiction. The hybrid mismatch rule should not apply, however, where the mismatch would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.

(20) In respect of payments made by a hybrid entity to its owner, or deemed payments made between the head office and permanent establishment or between two or more permanent establishments, a hybrid mismatch could arise where the deduction without inclusion outcome results from the payment or deemed payment not being recognised in the payee jurisdiction. In that case, where the mismatch outcome is a consequence of the non-allocation of the payment or deemed payment, the payee jurisdiction is the jurisdiction where the payment or deemed payment is treated as being received under the laws of the payer jurisdiction. As with other hybrid entities and branch mismatches that give rise to deduction without inclusion outcomes, no hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction. In respect of this

category of hybrid mismatches, however, a mismatch outcome would only arise to the extent that the payer jurisdiction allows the deduction in respect of the payment or deemed payment to be set off against an amount that is not dual-inclusion income. If the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, then the requirement to make any adjustment under this Directive could be deferred until such time as the deduction is actually set off against non-dual-inclusion income in the payer jurisdiction.

(21) The hybrid mismatch definition should also capture double deduction outcomes regardless of whether they arise as a result of payments, expenses that are not treated as payments under domestic law or as a result of amortisation or depreciation losses. As with deemed payments and payments made by a hybrid entity that are disregarded by the payee, a hybrid mismatch should only arise, however, to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income. This means that if the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, the requirement to make an adjustment under this Directive could be deferred until such time as the deduction is actually set off against non-dual-inclusion income in the payer jurisdiction.

(22) Differences in tax outcomes that are solely attributable to differences in the value ascribed to a payment, including through the application of transfer pricing, should not fall within the scope of a hybrid mismatch. Furthermore, as jurisdictions use different tax periods and have different rules for recognising when items of income or expenditure have been derived or incurred, those timing differences should not generally be treated as giving rise to mismatches in tax outcomes. However, a deductible payment under a financial instrument that cannot reasonably be expected to be included in income within a reasonable period of time should be treated as giving rise to a hybrid mismatch if that deduction without inclusion outcome is attributable to differences in the characterisation of the financial instrument or payments made under it. It should be understood that a mismatch outcome could arise if a payment made under a financial instrument is not included in income within a reasonable period of time. Such a payment should be treated as included in income within a reasonable period of time, if included by the payee within 12 months of the end of the payer's tax period or as determined under the arm's length principle. Member States could require that a payment be included within a fixed period of time in order to avoid giving rise to a mismatch outcome and secure tax control.

(23) Hybrid transfers could give rise to a difference in tax treatment if, as a result of an arrangement to transfer a financial instrument, the underlying return on that instrument was treated as derived by more than one of the parties to the arrangement. In those cases, the payment under the hybrid transfer could give rise to a deduction for the payer while being treated as a return on the underlying instrument by the payee. This difference in tax treatment could lead to a deduction without inclusion outcome or to the generation of a surplus tax credit for the tax withheld at source on the underlying instrument. Such mismatches should therefore be eliminated. In the case of a deduction without inclusion, the same rules should apply as for neutralising mismatches from payments under a hybrid financial instrument. In the case of hybrid transfers that have been structured to produce surplus tax credits, the Member State concerned should prevent the payer from using the surplus credit to obtain a tax advantage including through the application of a general anti-abuse rule consistent with Article 6 of Directive (EU) 2016/1164.

(24) It is necessary to provide for a rule that allows Member States to tackle discrepancies in the transposition and implementation of this Directive resulting in a hybrid mismatch despite the fact that Member States act in compliance with this Directive. Where such a situation arises and the primary rule provided for in this Directive does not apply, a secondary rule should apply. Nevertheless, the application of both the primary and secondary rules only apply to hybrid mismatches as defined by this Directive and should not affect the general features of the tax system of a Member State.

(25) Imported mismatches shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralise hybrid mismatches. A deductible payment in a Member State can be used to fund expenditure involving a hybrid mismatch. To counter such imported mismatches, it is necessary to include rules that disallow the deduction of a payment if the corresponding income from that payment is set off, directly or indirectly, against a deduction that arises under a hybrid mismatch giving rise to a double deduction or a deduction without inclusion between third countries.

(26) A dual resident mismatch could lead to a double deduction if a payment made by a dual resident taxpayer is deducted under the laws of both jurisdictions where the taxpayer is resident. As dual resident mismatches could give rise to double deduction outcomes, they should fall within the scope of this Directive. A Member State should deny the duplicate deduction arising in respect of a dual resident company to the extent that this payment is set off against an amount that is not treated as income under the laws of the other jurisdiction.

(27) The objective of this Directive is to improve the resilience of the internal market as a whole against hybrid mismatches. This cannot be sufficiently achieved by the Member States acting individually, given that national corporate tax systems are disparate and that independent action by Member States would only replicate the existing fragmentation of the internal market in direct taxation. It would thus allow inefficiencies and distortions to persist in the interaction of distinct national measures. This would result in a lack of coordination. That objective can rather, due to the cross-border nature of hybrid mismatches and the need to adopt solutions that function for the internal market as a whole, be better achieved at Union level. The Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective. By setting the required level of protection for the internal market, this Directive only aims to achieve the essential degree of coordination within the Union that is necessary to achieve its objective.

(28) In implementing this Directive, Member States should use the applicable explanations and examples in the OECD BEPS report on Action 2 as a source of illustration or interpretation to the extent that they are consistent with the provisions of this Directive and with Union law.

(29) The hybrid mismatch rules in Article 9(1) and (2) only apply to the extent that the situation involving a taxpayer gives rise to a mismatch outcome. No mismatch outcome should arise when an arrangement is subject to adjustment under Article 9(5) or 9a and, accordingly, arrangements that are subject to adjustment under those parts of this Directive should not be subject to any further adjustment under the hybrid mismatch rules.

(30) Where the provisions of another directive, such as those in Council Directive 2011/96/EU [1], lead to the neutralisation of the mismatch in tax outcomes, there should be no scope for the application of the hybrid mismatch rules provided for in this Directive.

(31) The Commission should evaluate the implementation of this Directive 5 years after its entry into force and report to the Council thereon. Member States should communicate to the Commission all information necessary for this evaluation.

(32) Directive (EU) 2016/1164 should therefore be amended accordingly,

HAS ADOPTED THIS DIRECTIVE:

Article 1

Directive (EU) 2016/1164 is amended as follows:

(1) Article 1 is replaced by the following:

‘*Article 1*

Scope

1. This Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country.

2. Article 9a also applies to all entities that are treated as transparent for tax purposes by a Member State.’;

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[1] Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 345, 29.12.2011, p. 8).

(2) Article 2 is amended as follows:

(a) in point (4), the last subparagraph is replaced by the following:

'For the purposes of Articles 9 and 9a:

(a) Where the mismatch outcome arises under points (b), (c), (d), (e) or (g) of the first subparagraph of point (9) of this Article or where an adjustment is required under Article 9(3) or Article 9a, the definition of associated enterprise is modified so that the 25 per cent requirement is replaced by a 50 per cent requirement;

(b) a person who acts together with another person in respect of the voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other person;

(c) an associated enterprise also means an entity that is part of the same consolidated group for financial accounting purposes as the taxpayer, an enterprise in which the taxpayer has a significant influence in the management or an enterprise that has a significant influence in the management of the taxpayer.';

(b) point (9) is replaced by the following:

'(9) "hybrid mismatch" means a situation involving a taxpayer or, with respect to Article 9(3), an entity where:

(a) a payment under a financial instrument gives rise to a deduction without inclusion outcome and:

(i) such payment is not included within a reasonable period of time; and

(ii) the mismatch outcome is attributable to differences in the characterisation of the instrument or the payment made under it.

For the purposes of the first subparagraph, a payment under a financial instrument shall be treated as included in income within a reasonable period of time where:

(i) the payment is included by the jurisdiction of the payee in a tax period that commences within 12 months of the end of the payer's tax period; or

(ii) it is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future tax period and the terms of payment are those that would be expected to be agreed between independent enterprises;

(b) a payment to a hybrid entity gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction where the hybrid entity is established or registered and the jurisdiction of any person with a participation in that hybrid entity;

(c) a payment to an entity with one or more permanent establishments gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments between the head office and permanent establishment or between two or more permanent establishments of the same entity under the laws of the jurisdictions where the entity operates;

(d) a payment gives rise to a deduction without inclusion as a result of a payment to a disregarded permanent establishment;

(e) a payment by a hybrid entity gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction;

(f) a deemed payment between the head office and permanent establishment or between two or more permanent establishments gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction; or

(g) a double deduction outcome occurs.

For the purposes of this point (9):

(a) a payment representing the underlying return on a transferred financial instrument shall not give rise to a hybrid mismatch under point (a) of the first subparagraph where the payment is made by a financial trader under an on-market hybrid transfer provided the payer jurisdiction requires the financial trader to include as income all amounts received in relation to the transferred financial instrument;

(b) a hybrid mismatch shall only arise under points (e), (f) or (g) of the first subparagraph to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income;

(c) a mismatch outcome shall not be treated as a hybrid mismatch unless it arises between associated enterprises, between a taxpayer and an associated enterprise, between the head office and permanent establishment, between two or more permanent establishments of the same entity or under a structured arrangement.

For the purposes of this point (9) and Articles 9, 9a and 9b:

(a) "mismatch outcome" means a double deduction or a deduction without inclusion;

(b) "double deduction" means a deduction of the same payment, expenses or losses in the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered (payer jurisdiction) and in another jurisdiction (investor jurisdiction). In the case of a payment by a hybrid entity or permanent establishment the payer jurisdiction is the jurisdiction where the hybrid entity or permanent establishment is established or situated;

(c) "deduction without inclusion" means the deduction of a payment or deemed payment between the head office and permanent establishment or between two or more permanent establishments in any jurisdiction in which that payment or deemed payment is treated as made (payer jurisdiction) without a corresponding inclusion for tax purposes of that payment or deemed payment in the payee jurisdiction. The payee jurisdiction is any jurisdiction where that payment or deemed payment is received, or is treated as being received under the laws of any other jurisdiction;

(d) "deduction" means the amount that is treated as deductible from the taxable income under the laws of the payer or investor jurisdiction. The term "deductible" shall be construed accordingly;

(e) "inclusion" means the amount that is taken into account in the taxable income under the laws of the payee jurisdiction. A payment under a financial instrument shall not be treated as included to the extent that the payment qualifies for any tax relief solely due to the way that payment is characterised under the laws of the payee jurisdiction. The term "included" shall be construed accordingly;

(f) "tax relief" means a tax exemption, reduction in the tax rate or any tax credit or refund (other than a credit for taxes withheld at source);

(g) "dual inclusion income" means any item of income that is included under the laws of both jurisdictions where the mismatch outcome has arisen;

(h) "person" means an individual or entity;

(i) "hybrid entity" means any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure of one or more other persons under the laws of another jurisdiction;

(j) "financial instrument" means any instrument to the extent that it gives rise to a financing or equity return that is taxed under the rules for taxing debt, equity or derivatives under the laws of either the payee or payer jurisdictions and includes a hybrid transfer;

(k) "financial trader" is a person or entity engaged in the business of regularly buying and selling financial instruments on its own account for the purposes of making a profit;

I

(Legislative acts)

DIRECTIVES

COUNCIL DIRECTIVE (EU) 2016/1164

of 12 July 2016

laying down rules against tax avoidance practices that directly affect the functioning of the internal market

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 115 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Parliament [1],

Having regard to the opinion of the European Economic and Social Committee [2],

Acting in accordance with a special legislative procedure,

Whereas:

(1) The current political priorities in international taxation highlight the need for ensuring that tax is paid where profits and value are generated. It is thus imperative to restore trust in the fairness of tax systems and allow governments to effectively exercise their tax sovereignty. These new political objectives have been translated into concrete action recommendations in the context of the initiative against base erosion and profit shifting (BEPS) by the Organisation for Economic Cooperation and Development (OECD). The European Council has welcomed this work in its conclusions of 13-14 March 2013 and 19-20 December 2013. In response to the need for fairer taxation, the Commission, in its communication of 17 June 2015 sets out an action plan for fair and efficient corporate taxation in the European Union.

(2) The final reports on the 15 OECD Action Items against BEPS were released to the public on 5 October 2015. This output was welcomed by the Council in its conclusions of 8 December 2015. The Council conclusions stressed the need to find common, yet flexible, solutions at the EU level consistent with OECD BEPS conclusions. In addition, the conclusions supported an effective and swift coordinated implementation of the anti-BEPS measures at the EU level and considered that EU directives should be, where appropriate, the preferred vehicle for implementing OECD BEPS conclusions at the EU level. It is essential for the good functioning of the internal

(1) Not yet published in the Official Journal.
(2) Not yet published in the Official Journal.

market that, as a minimum, Member States implement their commitments under BEPS and more broadly, take action to discourage tax avoidance practices and ensure fair and effective taxation in the Union in a sufficiently coherent and coordinated fashion. In a market of highly integrated economies, there is a need for common strategic approaches and coordinated action, to improve the functioning of the internal market and maximise the positive effects of the initiative against BEPS. Furthermore, only a common framework could prevent a fragmentation of the market and put an end to currently existing mismatches and market distortions. Finally, national implementing measures which follow a common line across the Union would provide taxpayers with legal certainty in that those measures would be compatible with Union law.

(3) It is necessary to lay down rules in order to strengthen the average level of protection against aggressive tax planning in the internal market. As these rules would have to fit in 28 separate corporate tax systems, they should be limited to general provisions and leave the implementation to Member States as they are better placed to shape the specific elements of those rules in a way that fits best their corporate tax systems. This objective could be achieved by creating a minimum level of protection for national corporate tax systems against tax avoidance practices across the Union. It is therefore necessary to coordinate the responses of Member States in implementing the outputs of the 15 OECD Action Items against BEPS with the aim to improve the effectiveness of the internal market as a whole in tackling tax avoidance practices. It is therefore necessary to set a common minimum level of protection for the internal market in specific fields.

(4) It is necessary to establish rules applicable to all taxpayers that are subject to corporate tax in a Member State. Considering that it would result in the need to cover a broader range of national taxes, it is not desirable to extend the scope of this Directive to types of entities which are not subject to corporate tax in a Member State; that is, in particular, transparent entities. Those rules should also apply to permanent establishments of those corporate taxpayers which may be situated in other Member State(s). Corporate taxpayers may be resident for tax purposes in a Member State or be established under the laws of a Member State. Permanent establishments of entities resident for tax purposes in a third country should also be covered by those rules if they are situated in one or more Member State.

(5) It is necessary to lay down rules against the erosion of tax bases in the internal market and the shifting of profits out of the internal market. Rules in the following areas are necessary in order to contribute to achieving that objective: limitations to the deductibility of interest, exit taxation, a general anti-abuse rule, controlled foreign company rules and rules to tackle hybrid mismatches. Where the application of those rules gives rise to double taxation, taxpayers should receive relief through a deduction for the tax paid in another Member State or third country, as the case may be. Thus, the rules should not only aim to counter tax avoidance practices but also avoid creating other obstacles to the market, such as double taxation.

(6) In an effort to reduce their global tax liability, groups of companies have increasingly engaged in BEPS, through excessive interest payments. The interest limitation rule is necessary to discourage such practices by limiting the deductibility of taxpayers' exceeding borrowing costs. It is therefore necessary to fix a ratio for deductibility which refers to a taxpayer's taxable earnings before interest, tax, depreciation and amortisation (EBITDA). Member States could decrease this ratio or place time limits or restrict the amount of unrelieved borrowing costs that can be carried forward or back to ensure a higher level of protection. Given that the aim is to lay down minimum standards, it could be possible for Member States to adopt an alternative measure referring to a taxpayer's earnings before interest and tax (EBIT) and fixed in a way that it is equivalent to the EBITDA-based ratio. Member States could in addition to the interest limitation rule provided by this Directive also use targeted rules against intra-group debt financing, in particular thin capitalisation rules. Tax exempt revenues should not be set off against deductible borrowing costs. This is because only taxable income should be taken into account in determining how much interest may be deducted.

(7) Where the taxpayer is part of a group which files statutory consolidated accounts, the indebtedness of the overall group at worldwide level may be considered for the purpose of granting taxpayers entitlement to deduct higher amounts of exceeding borrowing costs. It may also be appropriate to lay down rules for an equity escape provision, where the interest limitation rule does not apply if the company can demonstrate that its equity over total assets ratio is broadly equal to or higher than the equivalent group ratio. The interest limitation rule should apply in relation to a taxpayer's exceeding borrowing costs without distinction of whether the costs originate in

debt taken out nationally, cross-border within the Union or with a third country, or whether they originate from third parties, associated enterprises or intra-group. Where a group includes more than one entity in a Member State, the Member State may consider the overall position of all group entities in the same State, including a separate entity taxation system to allow the transfer of profits or interest capacity between entities within a group, when applying rules that limit the deductibility of interest.

(8) To reduce the administrative and compliance burden of the rules without significantly diminishing their tax effect, it may be appropriate to provide for a safe harbour rule so that net interest is always deductible up to a fixed amount, when this leads to a higher deduction than the EBITDA-based ratio. Member States could reduce the fixed monetary threshold in order to ensure a higher level of protection of their domestic tax base. Since BEPS in principle takes place through excessive interest payments among entities which are associated enterprises, it is appropriate and necessary to allow the possible exclusion of standalone entities from the scope of the interest limitation rule given the limited risks of tax avoidance. In order to facilitate the transition to the new interest limitation rule, Member States could provide for a grandfathering clause that would cover existing loans to the extent that their terms are not subsequently modified, i.e. in case of a subsequent modification, the grandfathering would not apply to any increase in the amount or duration of the loan but would be limited to the original terms of the loan. Without prejudice to State aid rules, Member States could also exclude exceeding borrowing costs incurred on loans used to fund long-term public infrastructure projects considering that such financing arrangements present little or no BEPS risks. In this context, Member States should properly demonstrate that financing arrangements for public infrastructure projects present special features which justify such treatment vis-à-vis other financing arrangements subject to the restrictive rule.

(9) Although it is generally accepted that financial undertakings, i.e. financial institutions and insurance undertakings, should also be subject to limitations to the deductibility of interest, it is equally acknowledged that these two sectors present special features which call for a more customised approach. As the discussions in this field are not yet sufficiently conclusive in the international and Union context, it is not yet possible to provide specific rules in the financial and insurance sectors and Member States should therefore be able to exclude them from the scope of interest limitation rules.

(10) Exit taxes have the function of ensuring that where a taxpayer moves assets or its tax residence out of the tax jurisdiction of a State, that State taxes the economic value of any capital gain created in its territory even though that gain has not yet been realised at the time of the exit. It is therefore necessary to specify cases in which taxpayers are subject to exit tax rules and taxed on unrealised capital gains which have been built in their transferred assets. It is also helpful to clarify that transfers of assets, including cash, between a parent company and its subsidiaries fall outside the scope of the envisaged rule on exit taxation. In order to compute the amounts, it is critical to fix a market value for the transferred assets at the time of exit of the assets based on the arm's length principle. In order to ensure the compatibility of the rule with the use of the credit method, it is desirable to allow Member States to refer to the moment when the right to tax the transferred assets is lost. The right to tax should be defined at national level. It is also necessary to allow the receiving State to dispute the value of the transferred assets established by the exit State when it does not reflect such a market value. Member States could resort to this effect to existing dispute resolution mechanisms. Within the Union, it is necessary to address the application of exit taxation and illustrate the conditions for being compliant with Union law. In those situations, taxpayers should have the right to either immediately pay the amount of exit tax assessed or defer payment of the amount of tax by paying it in instalments over a certain number of years, possibly together with interest and a guarantee.

Member States could request, for this purpose, the taxpayers concerned to include the necessary information in a declaration. Exit tax should not be charged when the transfer of assets is of a temporary nature and the assets are set to revert to the Member State of the transferor, where the transfer takes place in order to meet prudential capital requirements or for the purpose of liquidity management or when it comes to securities' financing transactions or assets posted as collateral.

(11) General anti-abuse rules (GAARs) feature in tax systems to tackle abusive tax practices that have not yet been dealt with through specifically targeted provisions. GAARs have therefore a function aimed to fill in gaps, which

should not affect the applicability of specific anti-abuse rules. Within the Union, GAARs should be applied to arrangements that are not genuine; otherwise, the taxpayer should have the right to choose the most tax efficient structure for its commercial affairs. It is furthermore important to ensure that the GAARs apply in domestic situations, within the Union and vis-à-vis third countries in a uniform manner, so that their scope and results of application in domestic and cross-border situations do not differ. Member States should not be prevented from applying penalties where the GAAR is applicable. When evaluating whether an arrangement should be regarded as non-genuine, it could be possible for Member States to consider all valid economic reasons, including financial activities.

(12) Controlled foreign company (CFC) rules have the effect of re-attributing the income of a low-taxed controlled subsidiary to its parent company. Then, the parent company becomes taxable on this attributed income in the State where it is resident for tax purposes. Depending on the policy priorities of that State, CFC rules may target an entire low-taxed subsidiary, specific categories of income or be limited to income which has artificially been diverted to the subsidiary. In particular, in order to ensure that CFC rules are a proportionate response to BEPS concerns, it is critical that Member States that limit their CFC rules to income which has been artificially diverted to the subsidiary precisely target situations where most of the decision-making functions which generated diverted income at the level of the controlled subsidiary are carried out in the Member State of the taxpayer. With a view to limiting the administrative burden and compliance costs, it should also be acceptable that those Member States exempt certain entities with low profits or a low profit margin that give rise to lower risks of tax avoidance. Accordingly, it is necessary that the CFC rules extend to the profits of permanent establishments where those profits are not subject to tax or are tax exempt in the Member State of the taxpayer. However, there is no need to tax, under the CFC rules, the profits of permanent establishments which are denied the tax exemption under national rules because these permanent establishments are treated as though they were controlled foreign companies. In order to ensure a higher level of protection, Member States could reduce the control threshold, or employ a higher threshold in comparing the actual corporate tax paid with the corporate tax that would have been charged in the Member State of the taxpayer. Member States could, in transposing CFC rules into their national law, use a sufficiently high tax rate fractional threshold.

It is desirable to address situations both in third countries and within the Union. To comply with the fundamental freedoms, the income categories should be combined with a substance carve-out aimed to limit, within the Union, the impact of the rules to cases where the CFC does not carry on a substantive economic activity. It is important that tax administrations and taxpayers cooperate to gather the relevant facts and circumstances to determine whether the carve-out rule is to apply. It should be acceptable that, in transposing CFC rules into their national law, Member States use white, grey or black lists of third countries, which are compiled on the basis of certain criteria set out in this Directive and may include the corporate tax rate level, or use white lists of Member States compiled on that basis.

(13) Hybrid mismatches are the consequence of differences in the legal characterisation of payments (financial instruments) or entities and those differences surface in the interaction between the legal systems of two jurisdictions. The effect of such mismatches is often a double deduction (i.e. deduction in both states) or a deduction of the income in one state without inclusion in the tax base of the other. To neutralise the effects of hybrid mismatch arrangements, it is necessary to lay down rules whereby one of the two jurisdictions in a mismatch should deny the deduction of a payment leading to such an outcome. In this context, it is useful to clarify that measures aimed to tackle hybrid mismatches in this Directive are aimed to tackle mismatch situations attributable to differences in the legal characterisation of a financial instrument or entity and are not intended to affect the general features of the tax system of a Member State. Although Member States have agreed guidance, in the framework of the Group of the Code of Conduct on Business Taxation, on the tax treatment of hybrid entities and hybrid permanent establishments within the Union as well as on the tax treatment of hybrid entities in relations with third countries, it is still necessary to enact binding rules. It is critical that further work is undertaken on hybrid mismatches between Member States and third countries, as well as on other hybrid mismatches such as those involving permanent establishments.

(14) It is necessary to clarify that the implementation of the rules against tax avoidance provided in this Directive should not affect the taxpayers' obligation to comply with the arm's length principle or the Member State's right to adjust a tax liability upwards in accordance with the arm's length principle, where applicable.

(15) The European Data Protection Supervisor was consulted in accordance with Article 28(2) of Regulation (EC) No 45/2001 of the European Parliament and of the Council [1]. The right to protection of personal data according to Article 8 of the Charter of Fundamental Rights of the European Union as well as Directive 95/46/EC of the European Parliament and of the Council [2] applies to the processing of personal data carried out within the framework of this Directive.

(16) Considering that a key objective of this Directive is to improve the resilience of the internal market as a whole against cross-border tax avoidance practices, this cannot be sufficiently achieved by the Member States acting individually. National corporate tax systems are disparate and independent action by Member States would only replicate the existing fragmentation of the internal market in direct taxation. It would thus allow inefficiencies and distortions to persist in the interaction of distinct national measures. The result would be lack of coordination. Rather, by reason of the fact that much inefficiency in the internal market primarily gives rise to problems of a cross-border nature, remedial measures should be adopted at Union level. It is therefore critical to adopt solutions that function for the internal market as a whole and this can be better achieved at Union level. Thus, the Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective. By setting a minimum level of protection for the internal market, this Directive only aims to achieve the essential minimum degree of coordination within the Union for the purpose of materialising its objectives.

(17) The Commission should evaluate the implementation of this Directive four years after its entry into force and report to the Council thereon. Member States should communicate to the Commission all information necessary for this evaluation.

HAS ADOPTED THIS DIRECTIVE:

CHAPTER I

GENERAL PROVISIONS

Article 1

Scope

This Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country.

Article 2

Definitions

For the purposes of this Directive, the following definitions apply:

(1) 'borrowing costs' means interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance as defined in national law, including, without being limited to, payments under profit participating loans, imputed interest on instruments such as convertible bonds and zero coupon bonds, amounts under alternative financing arrangements, such as Islamic finance, the finance cost element of finance lease payments, capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest, amounts measured by reference to a funding return under transfer pricing rules where applicable, notional interest amounts under derivative instruments or hedging arrangements related to an

[1] Regulation (EC) No 45/2001 of the European Parliament and of the Council of 18 December 2000 on the protection of individuals with regard to the processing of personal data by the Community institutions and bodies and on the free movement of such data (OJ L 8, 12.1.2001, p. 1).

[2] Directive 95/46/EC of the European Parliament and the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data (OJ L 281, 23.11.1995, p. 31).

entity's borrowings, certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance, guarantee fees for financing arrangements, arrangement fees and similar costs related to the borrowing of funds;

(2) 'exceeding borrowing costs' means the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives according to national law;

(3) 'tax period' means a tax year, calendar year or any other appropriate period for tax purposes;

(4) 'associated enterprise' means:

(a) an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25 percent or more or is entitled to receive 25 percent or more of the profits of that entity;

(b) an individual or entity which holds directly or indirectly a participation in terms of voting rights or capital ownership in a taxpayer of 25 percent or more or is entitled to receive 25 percent or more of the profits of the taxpayer;

If an individual or entity holds directly or indirectly a participation of 25 percent or more in a taxpayer and one or more entities, all the entities concerned, including the taxpayer, shall also be regarded as associated enterprises.

For the purposes of Article 9 and where the mismatch involves a hybrid entity, this definition is modified so that the 25 percent requirement is replaced by a 50 percent requirement.

(5) 'financial undertaking' means any of the following entities:

(a) a credit institution or an investment firm as defined in point (1) of Article 4(1) of Directive 2004/39/EC of the European Parliament and of the Council ([1]) or an alternative investment fund manager (AIFM) as defined in point (b) of Article 4(1) of Directive 2011/61/EU of the European Parliament and of the Council ([2]) or an undertaking for collective investment in transferable securities (UCITS) management company as defined in point (b) of Article 2(1) of Directive 2009/65/EC of the European Parliament and of the Council ([3]);

(b) an insurance undertaking as defined in point (1) of Article 13 of Directive 2009/138/EC of the European Parliament and of the Council ([4]);

(c) a reinsurance undertaking as defined in point (4) of Article 13 of Directive 2009/138/EC;

(d) an institution for occupational retirement provision falling within the scope of Directive 2003/41/EC of the European Parliament and of the Council ([5]), unless a Member State has chosen not to apply that Directive in whole or in part to that institution in accordance with Article 5 of that Directive or the delegate of an institution for occupational retirement provision as referred to in Article 19(1) of that Directive;

(e) pension institutions operating pension schemes which are considered to be social security schemes covered by Regulation (EC) No 883/2004 of the European Parliament and of the Council ([6]) and Regulation (EC) No 987/2009 of the European Parliament and of the Council ([7]) as well as any legal entity set up for the purpose of investment of such schemes;

([1]) Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1).

([2]) Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 1.7.2011, p. 1).

([3]) Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32).

([4]) Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 335, 17.12.2009, p. 1).

([5]) Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (OJ L 235, 23.9.2003, p. 10).

([6]) Regulation (EC) No 883/2004 of the European Parliament and of the Council of 29 April 2004 on the coordination of social security systems (OJ L 166, 30.4.2004, p. 1).

([7]) Regulation (EC) No 987/2009 of the European Parliament and of the Council of 16 September 2009 laying down the procedure for implementing Regulation (EC) No 883/2004 on the coordination of social security systems (OJ L 284, 30.10.2009, p. 1).

(f) an alternative investment fund (AIF) managed by an AIFM as defined in point (b) of Article 4(1) of Directive 2011/61/EU or an AIF supervised under the applicable national law;

(g) UCITS in the meaning of Article 1(2) of Directive 2009/65/EC;

(h) a central counterparty as defined in point (1) of Article 2 of Regulation (EU) No 648/2012 of the European Parliament and of the Council ([1]);

(i) a central securities depository as defined in point (1) of Article 2(1) of Regulation (EU) No 909/2014 of the European Parliament and of the Council ([2]).

(6) 'transfer of assets' means an operation whereby a Member State loses the right to tax the transferred assets, whilst the assets remain under the legal or economic ownership of the same taxpayer;

(7) 'transfer of tax residence' means an operation whereby a taxpayer ceases to be resident for tax purposes in a Member State, whilst acquiring tax residence in another Member State or third country;

(8) 'transfer of a business carried on by a permanent establishment' means an operation whereby a taxpayer ceases to have taxable presence in a Member State whilst acquiring such presence in another Member State or third country without becoming resident for tax purposes in that Member State or third country;

(9) 'hybrid mismatch' means a situation between a taxpayer in one Member State and an associated enterprise in another Member State or a structured arrangement between parties in Member States where the following outcome is attributable to differences in the legal characterisation of a financial instrument or entity:

(a) a deduction of the same payment, expenses or losses occurs both in the Member State in which the payment has its source, the expenses are incurred or the losses are suffered and in another Member State ('double deduction'); or

(b) there is a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion for tax purposes of the same payment in the other Member State ('deduction without inclusion').

Article 3

Minimum level of protection

This Directive shall not preclude the application of domestic or agreement-based provisions aimed at safeguarding a higher level of protection for domestic corporate tax bases.

CHAPTER II

MEASURES AGAINST TAX AVOIDANCE

Article 4

Interest limitation rule

1. Exceeding borrowing costs shall be deductible in the tax period in which they are incurred only up to 30 percent of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA).

([1]) Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1).

([2]) Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 (OJ L 257, 28.8.2014, p. 1).

For the purpose of this Article, Member States may also treat as a taxpayer:

(a) an entity which is permitted or required to apply the rules on behalf of a group, as defined according to national tax law;

(b) an entity in a group, as defined according to national tax law, which does not consolidate the results of its members for tax purposes.

In such circumstances, exceeding borrowing costs and the EBITDA may be calculated at the level of the group and comprise the results of all its members.

2. The EBITDA shall be calculated by adding back to the income subject to corporate tax in the Member State of the taxpayer the tax-adjusted amounts for exceeding borrowing costs as well as the tax-adjusted amounts for depreciation and amortisation. Tax exempt income shall be excluded from the EBITDA of a taxpayer.

3. By derogation from paragraph 1, the taxpayer may be given the right:

(a) to deduct exceeding borrowing costs up to EUR 3 000 000;

(b) to fully deduct exceeding borrowing costs if the taxpayer is a standalone entity.

For the purposes of the second subparagraph of paragraph 1, the amount of EUR 3 000 000 shall be considered for the entire group.

For the purposes of point (b) of the first subparagraph, a standalone entity means a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment.

4. Member States may exclude from the scope of paragraph 1 exceeding borrowing costs incurred on:

(a) loans which were concluded before 17 June 2016, but the exclusion shall not extend to any subsequent modification of such loans;

(b) loans used to fund a long-term public infrastructure project where the project operator, borrowing costs, assets and income are all in the Union.

For the purposes of point (b) of the first subparagraph, a long-term public infrastructure project means a project to provide, upgrade, operate and/or maintain a large-scale asset that is considered in the general public interest by a Member State.

Where point (b) of the first subparagraph applies, any income arising from a long-term public infrastructure project shall be excluded from the EBITDA of the taxpayer, and any excluded exceeding borrowing cost shall not be included in the exceeding borrowing costs of the group vis-à-vis third parties referred to in point (b) of paragraph 5.

5. Where the taxpayer is a member of a consolidated group for financial accounting purposes, the taxpayer may be given the right to either:

(a) fully deduct its exceeding borrowing costs if it can demonstrate that the ratio of its equity over its total assets is equal to or higher than the equivalent ratio of the group and subject to the following conditions:

  (i) the ratio of the taxpayer's equity over its total assets is considered to be equal to the equivalent ratio of the group if the ratio of the taxpayer's equity over its total assets is lower by up to two percentage points; and

  (ii) all assets and liabilities are valued using the same method as in the consolidated financial statements referred to in paragraph 8;

or

(b) deduct exceeding borrowing costs at an amount in excess of what it would be entitled to deduct under paragraph 1. This higher limit to the deductibility of exceeding borrowing costs shall refer to the consolidated group for financial accounting purposes in which the taxpayer is a member and be calculated in two steps:

(i) first, the group ratio is determined by dividing the exceeding borrowing costs of the group vis-à-vis third-parties over the EBITDA of the group; and

(ii) second, the group ratio is multiplied by the EBITDA of the taxpayer calculated pursuant to paragraph 2.

6. The Member State of the taxpayer may provide for rules either:

(a) to carry forward, without time limitation, exceeding borrowing costs which cannot be deducted in the current tax period under paragraphs 1 to 5;

(b) to carry forward, without time limitation, and back, for a maximum of three years, exceeding borrowing costs which cannot be deducted in the current tax period under paragraphs 1 to 5; or

(c) to carry forward, without time limitation, exceeding borrowing costs and, for a maximum of five years, unused interest capacity, which cannot be deducted in the current tax period under paragraphs 1 to 5.

7. Member States may exclude financial undertakings from the scope of paragraphs 1 to 6, including where such financial undertakings are part of a consolidated group for financial accounting purposes.

8. For the purpose of this Article, the consolidated group for financial accounting purposes consists of all entities which are fully included in consolidated financial statements drawn up in accordance with the International Financial Reporting Standards or the national financial reporting system of a Member State. The taxpayer may be given the right to use consolidated financial statements prepared under other accounting standards.

Article 5

Exit taxation

1. A taxpayer shall be subject to tax at an amount equal to the market value of the transferred assets, at the time of exit of the assets, less their value for tax purposes, in any of the following circumstances:

(a) a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country in so far as the Member State of the head office no longer has the right to tax the transferred assets due to the transfer;

(b) a taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer;

(c) a taxpayer transfers its tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State;

(d) a taxpayer transfers the business carried on by its permanent establishment from a Member State to another Member State or to a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer.

2. A taxpayer shall be given the right to defer the payment of an exit tax referred to in paragraph 1, by paying it in instalments over five years, in any of the following circumstances:

(a) a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country that is party to the Agreement on the European Economic Area (EEA Agreement);

(b) a taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or a third country that is party to the EEA Agreement;

(c) a taxpayer transfers its tax residence to another Member State or to a third country that is party to the EEA Agreement;

(d) a taxpayer transfers the business carried on by its permanent establishment to another Member State or a third country that is party to the EEA Agreement.

This paragraph shall apply to third countries that are party to the EEA Agreement if they have concluded an agreement with the Member State of the taxpayer or with the Union on the mutual assistance for the recovery of tax claims, equivalent to the mutual assistance provided for in Council Directive 2010/24/EU ([1]).

3. If a taxpayer defers the payment in accordance with paragraph 2, interest may be charged in accordance with the legislation of the Member State of the taxpayer or of the permanent establishment, as the case may be.

If there is a demonstrable and actual risk of non-recovery, taxpayers may also be required to provide a guarantee as a condition for deferring the payment in accordance with paragraph 2.

The second subparagraph shall not apply where the legislation in the Member State of the taxpayer or of the permanent establishment provides for the possibility of recovery of the tax debt through another taxpayer which is member of the same group and is resident for tax purposes in that Member State.

4. Where paragraph 2 applies, the deferral of payment shall be immediately discontinued and the tax debt becomes recoverable in the following cases:

(a) the transferred assets or the business carried on by the permanent establishment of the taxpayer are sold or otherwise disposed of;

(b) the transferred assets are subsequently transferred to a third country;

(c) the taxpayer's tax residence or the business carried on by its permanent establishment is subsequently transferred to a third country;

(d) the taxpayer goes bankrupt or is wound up;

(e) the taxpayer fails to honour its obligations in relation to the instalments and does not correct its situation over a reasonable period of time, which shall not exceed 12 months.

Points (b) and (c) shall not apply to third countries that are party to the EEA Agreement if they have concluded an agreement with the Member State of the taxpayer or with the Union on the mutual assistance for the recovery of tax claims, equivalent to the mutual assistance provided for in Directive 2010/24/EU.

5. Where the transfer of assets, tax residence or the business carried on by a permanent establishment is to another Member State, that Member State shall accept the value established by the Member State of the taxpayer or of the permanent establishment as the starting value of the assets for tax purposes, unless this does not reflect the market value.

6. For the purposes of paragraphs 1 to 5, 'market value' is the amount for which an asset can be exchanged or mutual obligations can be settled between willing unrelated buyers and sellers in a direct transaction.

7. Provided that the assets are set to revert to the Member State of the transferor within a period of 12 months, this Article shall not apply to asset transfers related to the financing of securities, assets posted as collateral or where the asset transfer takes place in order to meet prudential capital requirements or for the purpose of liquidity management.

([1]) Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures (OJ L 84, 31.3.2010, p. 1).

Article 6

General anti-abuse rule

1. For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

2. For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

3. Where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law.

Article 7

Controlled foreign company rule

1. The Member State of a taxpayer shall treat an entity, or a permanent establishment of which the profits are not subject to tax or are exempt from tax in that Member State, as a controlled foreign company where the following conditions are met:

(a) in the case of an entity, the taxpayer by itself, or together with its associated enterprises holds a direct or indirect participation of more than 50 percent of the voting rights, or owns directly or indirectly more than 50 percent of capital or is entitled to receive more than 50 percent of the profits of that entity; and

(b) the actual corporate tax paid on its profits by the entity or permanent establishment is lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment.

For the purposes of point (b) of the first subparagraph, the permanent establishment of a controlled foreign company that is not subject to tax or is exempt from tax in the jurisdiction of the controlled foreign company shall not be taken into account. Furthermore the corporate tax that would have been charged in the Member State of the taxpayer means as computed according to the rules of the Member State of the taxpayer.

2. Where an entity or permanent establishment is treated as a controlled foreign company under paragraph 1, the Member State of the taxpayer shall include in the tax base:

(a) the non-distributed income of the entity or the income of the permanent establishment which is derived from the following categories:

   (i) interest or any other income generated by financial assets;

   (ii) royalties or any other income generated from intellectual property;

   (iii) dividends and income from the disposal of shares;

   (iv) income from financial leasing;

   (v) income from insurance, banking and other financial activities;

   (vi) income from invoicing companies that earn sales and services income from goods and services purchased from and sold to associated enterprises, and add no or little economic value;

This point shall not apply where the controlled foreign company carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances.

Where the controlled foreign company is resident or situated in a third country that is not party to the EEA Agreement, Member States may decide to refrain from applying the preceding subparagraph.

or

(b) the non-distributed income of the entity or permanent establishment arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

For the purposes of this point, an arrangement or a series thereof shall be regarded as non-genuine to the extent that the entity or permanent establishment would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income.

3. Where, under the rules of a Member State, the tax base of a taxpayer is calculated according to point (a) of paragraph 2, the Member State may opt not to treat an entity or permanent establishment as a controlled foreign company under paragraph 1 if one third or less of the income accruing to the entity or permanent establishment falls within the categories under point (a) of paragraph 2.

Where, under the rules of a Member State, the tax base of a taxpayer is calculated according to point (a) of paragraph 2, the Member State may opt not to treat financial undertakings as controlled foreign companies if one third or less of the entity's income from the categories under point (a) of paragraph 2 comes from transactions with the taxpayer or its associated enterprises.

4. Member States may exclude from the scope of point (b) of paragraph 2 an entity or permanent establishment:

(a) with accounting profits of no more than EUR 750 000, and non-trading income of no more than EUR 75 000; or

(b) of which the accounting profits amount to no more than 10 percent of its operating costs for the tax period.

For the purpose of point (b) of the first subparagraph, the operating costs may not include the cost of goods sold outside the country where the entity is resident, or the permanent establishment is situated, for tax purposes and payments to associated enterprises.

Article 8

Computation of controlled foreign company income

1. Where point (a) of Article 7(2) applies, the income to be included in the tax base of the taxpayer shall be calculated in accordance with the rules of the corporate tax law of the Member State where the taxpayer is resident for tax purposes or situated. Losses of the entity or permanent establishment shall not be included in the tax base but may be carried forward, according to national law, and taken into account in subsequent tax periods.

2. Where point (b) of Article 7(2) applies, the income to be included in the tax base of the taxpayer shall be limited to amounts generated through assets and risks which are linked to significant people functions carried out by the controlling company. The attribution of controlled foreign company income shall be calculated in accordance with the arm's length principle.

3. The income to be included in the tax base shall be calculated in proportion to the taxpayer's participation in the entity as defined in point (a) of Article 7(1).

4. The income shall be included in the tax period of the taxpayer in which the tax year of the entity ends.

5. Where the entity distributes profits to the taxpayer, and those distributed profits are included in the taxable income of the taxpayer, the amounts of income previously included in the tax base pursuant to Article 7 shall be deducted from the tax base when calculating the amount of tax due on the distributed profits, in order to ensure there is no double taxation.

6. Where the taxpayer disposes of its participation in the entity or of the business carried out by the permanent establishment, and any part of the proceeds from the disposal previously has been included in the tax base pursuant to Article 7, that amount shall be deducted from the tax base when calculating the amount of tax due on those proceeds, in order to ensure there is no double taxation.

7. The Member State of the taxpayer shall allow a deduction of the tax paid by the entity or permanent establishment from the tax liability of the taxpayer in its state of tax residence or location. The deduction shall be calculated in accordance with national law.

Article 9

Hybrid mismatches

1. To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source.

2. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

CHAPTER III

FINAL PROVISIONS

Article 10

Review

1. The Commission shall evaluate the implementation of this Directive, in particular the impact of Article 4, by 9 August 2020 and report to the Council thereon. The report by the Commission shall, if appropriate, be accompanied by a legislative proposal.

2. Member States shall communicate to the Commission all information necessary for evaluating the implementation of this Directive.

3. Member States referred to in Article 11(6) shall communicate to the Commission before 1 July 2017 all information necessary for evaluating the effectiveness of the national targeted rules for preventing base erosion and profit shifting risks (BEPS).

Article 11

Transposition

1. Member States shall, by 31 December 2018, adopt and publish the laws, regulations and administrative provisions necessary to comply with this Directive. They shall communicate to the Commission the text of those provisions without delay.

They shall apply those provisions from 1 January 2019.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

2. Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

3. Where this Directive mentions a monetary amount in euros (EUR), Member States whose currency is not the euro may opt to calculate the corresponding value in the national currency on 12 July 2016.

4. By way of derogation from Article 5(2), Estonia may, for as long as it does not tax undistributed profits, consider a transfer of assets in monetary or non-monetary form, including cash, from a permanent establishment situated in Estonia to a head office or another permanent establishment in another Member State or in a third country that is a party to the EEA Agreement as profit distribution and charge income tax, without giving taxpayers the right to defer the payment of such tax.

5. By way of derogation from paragraph 1, Member States shall, by 31 December 2019, adopt and publish, the laws, regulations and administrative provisions necessary to comply with Article 5. They shall communicate to the Commission the text of those provisions without delay.

They shall apply those provisions from 1 January 2020.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

6. By way of derogation from Article 4, Member States which have national targeted rules for preventing BEPS risks at 8 August 2016, which are equally effective to the interest limitation rule set out in this Directive, may apply these targeted rules until the end of the first full fiscal year following the date of publication of the agreement between the OECD members on the official website on a minimum standard with regard to BEPS Action 4, but at the latest until 1 January 2024.

Article 12

Entry into force

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 13

Addressees

This Directive is addressed to the Member States.

Done at Brussels, 12 July 2016.

For the Council

The President

P. KAŽIMÍR

<u>Materials Relating to Act II: Treaty Overrides on Prop. Regs. 59A and 267A</u>

267A Deemed Branch Payments Rule and Commentary

Prop. Regs. 267A REG-104352-18; 83 F.R. 67612-67651; 2019-3 IRB 357

From Preamble

II.D.3. Deemed Branch Payments

Proposed §1.267A-2(c) addresses deemed branch payments. These payments result in a D/NI outcome when, under an income tax treaty, a deductible payment is deemed to be made by a permanent establishment to its home office and offsets income not taxable to the home office, but the payment is not taken into account under the home office's tax law.

In general, the proposed regulations define a deemed branch payment as interest or royalty considered paid by a U.S. permanent establishment to its home office under an income tax treaty between the United States and the home office country. <u>See</u> proposed §1.267A-2(c)(2). Thus, for example, a deemed branch payment includes an amount allowed as a deduction in computing the business profits of a U.S. permanent establishment with respect to the use of intellectual property developed by the home office. <u>See</u>, for example, the U.S. Treasury Department Technical Explanation to the income tax convention between the United States and Belgium, signed November 27, 2006 ("[T]he OECD Transfer Pricing Guidelines apply, by analogy, in determining the profits attributable to a permanent establishment.").

When a specified payment is a deemed branch payment, it is a disqualified hybrid amount if the home office's tax law provides an exclusion or exemption for income attributable to the branch. In these cases, a deduction for the deemed branch payment would offset non-dual inclusion income and therefore give rise to a D/NI outcome. If the home office's tax law does not have an exclusion or exemption for income attributable to the branch, then, because U.S. permanent establishments cannot consolidate or otherwise share losses with U.S. taxpayers, there would generally not be an opportunity for a deduction for the deemed branch payment to offset non-dual inclusion income.

Prop. Reg. §1.267A-2(c)(2) Text

(c) *Deemed branch payments*—(1) *In general*. If a specified payment is a deemed branch payment, then the payment is a disqualified hybrid amount if the tax law of the home office provides an exclusion or exemption for income attributable to the branch. *See* § 1.267A-6(c)(4).

(2) *Definition of deemed branch payment.* The term *deemed branch payment* means, with respect to a U.S. taxable branch that is a U.S. permanent establishment of a treaty resident eligible for benefits under an income tax treaty between the United States and the treaty country, any amount of interest or royalties allowable as a deduction in computing the business profits of the U.S. permanent establishment, to the extent the amount is deemed paid to the home office (or other branch of the home office) and is not regarded (or otherwise taken into account) under the home office's tax law (or the other branch's tax law).

A deemed branch payment may be otherwise taken into account for this purpose if, for example, under the home office's tax law a corresponding amount of interest or royalties is allocated and attributable to the U.S. permanent establishment and is therefore not deductible.

Commentary Reaction to Prop. Reg. 267A Deemed Branch Rule

NEW YORK STATE BAR ASSOCIATION TAX SECTION
REPORT ON PROPOSED REGULATIONS UNDER SECTIONS 267A, 245A(e), AND 1503(d) (February 26, 2019)

IV.A.4.l.i.

l. Deemed Branch Payments

i. Deemed branch payments generally

Deemed branch payments under Prop. Reg. §1.267A-2(c)(2) exist only where a non-U.S. corporation has a US branch that qualifies as a "permanent establishment" ("**PE**") under a tax treaty between that corporation's country of residence and the U.S., the non-U.S. corporation uses that treaty's rules for computing the taxable profits of that PE in lieu of using the U.S. rules standing-alone, that treaty's rules for determining the business profits of the PE create a deemed deductible payment of interest or royalties from the PE to the home office, and notwithstanding the treaty's provisions the treaty party's tax law does not require a corresponding Inclusion in taxable income to the home office. This mismatch is to be distinguished from situations where the home office's tax law and the branch's tax law have a mismatch with respect to the allocation between the home office and the branch of actual payments made to or received from third parties. Instead, deemed branch payments are fictional payments that are deemed to exist only for purposes of computing the branch's net income subject to US tax under a treaty. They are deemed to exist only because the United States entered into a tax treaty with the other jurisdiction and provided for the branch to compute its taxable business profit *as if* the branch and the home office were separate entities.[182] They can exist only if the foreign owner of the branch claims the benefits of the treaty with respect to the computation of the branch's taxable business profits (as distinguished from following the results provided for by the Code without the overlay of the treaty).

At this time we have no specific recommendation with regards to deemed branch payments, but we believe that this category raises issues that should be carefully considered.

As noted above, these deemed payments are a product of bilateral tax treaties that the US has entered into with other countries. Under each such treaty, the US and the applicable counterparty have agreed on a method for computing the taxable business profits of PEs operating in their jurisdiction and agreed that they will impose tax on only that amount of business profits. That method includes allowing the PE a deduction for interest or royalties deemed to be paid to the home office, without regard to whether the home office is required to pay tax on that deemed income in the counterparty jurisdiction. Now, the US would be creating a new condition on the allowance of the deduction based upon an intervening change in US law.

We are not addressing whether the US has the legal authority to do this — there is ample commentary on the later-in-time rule in the context of changes in U.S. law that impact existing tax treaties (so-called "treaty overrides"), including by us in prior Tax Section reports.[183] One factor that is discussed in the commentary is whether Congress expressed an intention to override treaties. Here, the authority for the deemed branch payments would be the regulatory grant in Section 267A(e)(2).[184] The discussion in the Joint Committee's Technical Explanation with respect to extending the rules to branches consists of a lengthy footnote that addresses specified payments made by a U.S. corporation to a U.S. branch of a related foreign corporation. In the first example, the U.S. branch is not taxable in the U.S. and in the second example, the U.S. sees the payment as income of the home office. There is no discussion in the legislative history of deemed payments from a branch pursuant to a treaty.

Other considerations relevant specifically to treaty overrides through Treasury Regulations are discussed extensively in *National Westminster Bank, PLC* v. *U.S.*[185]

While the legislative history does not explicitly refer to deemed branch payments, it does, as discussed above, refer to the OECD hybrid reports and expresses an intention to be following the recommendations in those reports to some extent. The OECD Recommendations are also significant here in evaluating the possibility of a treaty override by regulation.

The OECD's Branch Mismatch Report includes, as Recommendation 3, the application of hybrid disallowance rules to deemed payments by a branch to its home office where the home office's tax rules do not include the deemed payment in taxable income (because the payment is not regarded or is otherwise exempt). It is not clear, however, if the recommendation in the report is limited to deemed payments created unilaterally under the law of the jurisdiction where the branch is operating and is not intended to be applied where the deemed payment is the result of a consensus reached between the two applicable countries as to the appropriate profits to be taxed by the jurisdiction where the branch is operating. There are numerous places in the OECD Branch Mismatch Report that indicate that Recommendation 3 is not intended to apply where the two countries have reached an agreement regarding the treatment of the branch.[186] Accordingly, whether the OECD Branch Mismatch Report is support for Congress intending a treaty override and whether it is support for the existence of an international consensus is questionable. The OECD Branch Mismatch Report cites to the anti-hybrid rules adopted by the U.K. in 2017 and those adopted by the E.U. in 2017 as indicators of the international consensus regarding the anti-hybrid rules that should apply to branches and both of those rules are, like Recommendation 3, arguably unclear as to whether they apply only where there is no governing treaty provision, but a fair reading of both of them is that they are so limited.

The treaty provision that provides for this type of a deemed payment is based upon the OECD's approach to determining the business profits of PEs (the "**Authorized OECD Approach**" or "**AOA**") and applies transfer pricing principles as if the branch and the home office were separate (but related) legal entities. The AOA has been embraced by the international community, including the US, and is reflected in the US Model Convention. The specific provision in the US Model Treaty reads as follows:

> For the purposes of this Article, the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 of this Article are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

The deemed branch payment rule is an additional rule that would apply *after* the application of the treaty provision. While this may be viewed as supporting a position that the deemed branch payment rule is contrary to the international consensus, there is an alternative perspective to be considered.

The Preamble indicates that the drafters see the deemed branch payment rule as a corollary to the rules that apply to specified payments by entities.[187] This approach makes sense in that the deemed payment exists only because the AOA treats the branch as a separate entity. If that fiction were true, then the hybrid transaction rule likely would have applied. So there is a need to back up the hybrid transaction rule with a deemed branch payment rule in order to ensure that branches (and the AOA) are not used to avoid the application of the basic hybrid transaction rule. Expressed in this way, the rule seems entirely necessary and appropriate. There are also portions of the OECD Branch Mismatch Report that could be understood to establish that Recommendation 3 is based upon this perspective and is intended to have this effect.

In light of the above considerations, including prior case law, and possible uncertainty about the status of the rule, we recommend that, if the rule is retained in final regulations, that there be a discussion of these considerations and the support for the rule.[188]

[182]Interestingly, the rule appears to apply without regard to how the home office's tax law would treat an actual payment of interest or royalties, and in this respect is distinct from most of the other Section 267A categories.

[183]NYSBA Tax Section, Report No. 1398 on Sections 864(c)(8) and 1446(f) (Aug. 2018); NYSBA Tax Section, Report No. 1364 on Proposed Section 2801 Regulations (Jan 2017); Avi-Yonah and Wells, “The BEAT and Treaty Overrides: A Brief Response to Rosenbloom and Shaheen”, Tax Analysts' Worldwide Tax Daily (Nov. 7, 2018).

[184]“(e) Regulations. -- The Secretary shall issue such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this section, including regulations or other guidance providing for — (2) rules for the application of this section to branches or domestic entities”.

[185]512 F.3d 1347 (Fed. Cir. 2008); *see also* Reinhold and Harrington, *What NatWest Tells US About Tax Treaty Interpretation*, Tax Analysts Doc 2008-5866 (2008).

[186]In addition, the Report refers throughout to the intent to preserving a country's obligations under existing tax treaties. See OECD Branch Mismatch Report at paragraphs 28 (“Any adjustments under the recommendations set out in this report should not affect the allocation of taxing rights under a tax treaty.”); 35 (“provided any adjustment is consistent with a jurisdiction's tax treaty obligations, and tax policy settings in that jurisdiction.”); 26 (“The recommendations in Chapter 1 should not, however, be interpreted as requiring countries to make any change to deliberate policy decisions they have made, including in respect of the territorial scope of their tax regime, and do not purport to affect a country's obligations under a tax treaty.”); 40 (“should also be noted that the residence jurisdiction may be prevented from restricting the scope of the branch exemption in those cases where the tax treaty in effect between the residence and branch jurisdiction contains a provision equivalent to . . . .”); and 57 (“In these cases the residence jurisdiction may be prevented from restricting the scope of the branch exemption under Recommendation 1 owing to the overriding effect of the tax treaty.”).

[187]OIRA Analysis at 67628.

[188]In the event that Final Regulations remove the deemed branch payment rule, we recommend they retain the clarification that deemed branch payments are not disregarded payments subject to Prop. Reg. 1.267A-2(b).

Silicon Valley Tax Directors, Comments on proposed §§ 245A(e) and 267A regulations in REG–104352–18 February 26, 2019

4. The deemed branch payments rule of Prop. § 1.267A-2(c) should be withdrawn because the rule is inconsistent with U.S. treaty obligations

Under Prop. § 1.267A-2(c), if a specified payment is a "deemed branch payment," the payment is a disqualified hybrid amount if the tax law of the home office provides an exclusion or exemption for income attributable to the branch. Deemed branch payments are payments deemed made, under an income tax treaty, by a U.S. branch to its home office, but the payment isn't regarded or otherwise taken into account under the home office's tax law. An example is an amount allowed as a deduction in computing the business profits of a U.S. PE for a deemed royalty paid to the home office for use of the home office's intellectual property.

The proposed rule conflicts with U.S. treaty obligations, which treat a PE as if it were a separate entity. For example, under Article 7(1) of the *United States Model Income Tax Convention* (February 17, 2016), a contracting state can tax the profits attributable to a PE in that contracting state. Under Article 7(2), such profits attributable to a PE are the profits the PE "might be expected to make, in particular in its dealings with other parts of the enterprise, <u>if it were a separate and independent enterprise</u> engaged in the same or similar activities under the same or similar conditions." Similar provisions are in most major U.S. treaties. For a PE to be treated as a separate enterprise, it must be allowed the same deductions a separate entity would be allowed. Disallowing a deduction for royalty and interest payments deemed made by a PE to its home office is inconsistent with the obligation under income tax treaties to treat the PE as a separate enterprise for purposes of computing the profits attributable to the PE. We accordingly recommend the rule in Prop. § 1.267A-2(c) be withdrawn.

59A Internal Dealings Rule and Commentary

Prop Reg 1.59A 59A REG-104259-18; 83 F.R. 65956-65997; 2019-2 IRB 300

From Preamble

III.A.4. Income Tax Treaties

Certain U.S. income tax treaties provide alternative approaches for the allocation or attribution of business profits of an enterprise of one contracting state to its permanent establishment in the other contracting state on the basis of assets used, risks assumed, and functions performed by the permanent establishment. The use of a treaty-based expense allocation or attribution method does not, in and of itself, create legal obligations between the U.S. permanent establishment and the rest of the enterprise. These proposed regulations recognize that as a result of a treaty-based expense allocation or attribution method, amounts equivalent to deductible payments may be allowed in computing the business profits of an enterprise with respect to transactions between the permanent establishment and the home office or other branches of the foreign corporation ("internal dealings"). The deductions from internal dealings would not be allowed under the Code and regulations, which generally allow deductions only for allocable and apportioned costs incurred by the enterprise as a whole. The proposed regulations require that these deductions from internal dealings allowed in computing the business profits of the permanent establishment be treated in a manner consistent with their treatment under the treaty-based position and be included as base erosion payments.

….internal dealings are …priced on the basis of assets used, risks assumed, and functions performed by the permanent establishment in a manner consistent with the arm's length principle. The approach in the proposed regulations creates parity between deductions for actual regarded payments between two separate corporations (which are subject to section 482), and internal dealings (which are generally priced in a manner consistent with the applicable treaty and, if applicable, the OECD Transfer Pricing Guidelines). The rules in the proposed regulations applicable to foreign corporations using this approach apply only to deductions attributable to internal dealings, and not to payments to entities outside of the enterprise, which are subject to the general base erosion payment rules as provided in proposed §1.59A-3(b)(4)(v)(A).

Text of Prop. Reg. 1.59A-3(b)(4)(v)

Coordination with certain tax treaties — (A) Allocable expenses. If a foreign corporation elects to determine its taxable income pursuant to business profits provisions of an income tax treaty rather than provisions of the Internal Revenue Code, or the regulations thereunder, for determining effectively connected income, and the foreign corporation does not apply §§1.882-5 and 1.861-8 to allocate interest and other deductions, then in applying paragraphs (b)(4)(i) and (ii) of this section, the foreign corporation must determine whether each allowable deduction attributed to the permanent establishment in its determination of business profits is a base erosion payment under paragraph (b)(1) of this section.

(B) Internal dealings under certain income tax treaties. If, pursuant to the terms of an applicable income tax treaty, a foreign corporation determines the profits attributable to a permanent establishment based on the assets used, risks assumed, and functions performed by the permanent establishment, then any deduction attributable to any amount paid or accrued (or treated as paid or accrued) by the permanent establishment to the foreign corporation's home office or to another branch of the foreign corporation (an “internal dealing”) is a base erosion payment to the extent such payment or accrual is described under paragraph (b)(1) of this section.

§1.59A-3 Base erosion payments and base erosion tax benefits.

(a) Scope. This section provides definitions and related rules regarding base erosion payments and base erosion tax benefits. Paragraph (b) of this section provides definitions and rules regarding base erosion payments. Paragraph (c) of this section provides rules for determining the amount of base erosion tax benefits. Paragraph (d) of this section provides examples illustrating the rules described in this section.

(b) Base erosion payments — (1) In general. Except as provided in paragraph (b)(3) of this section, a base erosion payment means —

(i) Any amount paid or accrued by the taxpayer to a foreign related party of the taxpayer and with respect to which a deduction is allowable under chapter 1 of subtitle A of the Internal Revenue Code;

Reactions to Prop Regs 59A Internal Dealings Rule

ABA 59A Prop Reg Report May 15 2019

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments on Proposed Regulations Addressing Section 59A

III. Comments . B. Comments regarding Base Erosion Payments and Base Erosion Tax Benefits

1. Background

Within the last several years, multiple jurisdictions have focused significantly on anti-base erosion measures. In 2015, the Organization for Economic Cooperation and Development (the "OECD") issued a series of reports providing insight and proposed guidance on how jurisdictions should approach base erosion and profit shifting ("BEPS") activities.[39] The OECD has defined base erosion as "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax jurisdictions where there is little or no economic activity (*i.e.*, no substance)."[40]

In similar fashion, and consistent with the articulated goals of the Act, section 59A was enacted to discourage base erosion activity and encourage both U.S. and non-U.S. multinationals to conduct business in the United States. In the Senate Finance Committee's unofficial summary of the Senate Bill, the policy problem was described as follows: "foreign-owned U.S. subsidiaries are able to reduce their U.S. tax liability by making deductible payments to a foreign parent . . . This often results in earnings stripping. . . . Foreign parents often take advantage of these deductions through the use of interest, royalties, management fees, or reinsurance payments from the U.S. subsidiary."[41]

At the same time, the various principles of tax reform as encompassed in the Act as a whole reflect a balance of considerations. As much as certain provisions, such as the BEAT, section 163(j), and section 267A are meant to protect U.S. fiscal interests against base erosion, other provisions such as section 168(k) (regarding bonus depreciation) and section 250 (regarding foreign-derived intangible income) incentivize taxpayers to increase their U.S. economic activities. In addition, the Proposed Regulations reflect a general intent to rely on existing tax principles to determine the treatment of payments or accruals as base erosion payments.[42] Taking these factors into account, we believe that the definition of "base erosion payment" should reflect a balance of the BEAT and broader tax reform policy considerations, while adopting an approach consistent with existing tax principles related to the use of stock as consideration.

As noted above, base erosion payments are defined in section 59A(d)(1) as "any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable" under Chapter 1 of the Code (a "(d)(1) base erosion payment").[43] Base erosion payments include "any amount paid or accrued by the taxpayer" to a related foreign person "in connection with the acquisition by the taxpayer from such person of property" that is depreciable or amortizable (a "(d)(2) base erosion payment").[44]

A BETB is (i) any deduction described in the definition of a (d)(1) base erosion payment which is allowed under Chapter 1 of the Code for the taxable year with respect to any base erosion payment; and (ii) in the case of a (d)(2) base erosion payment, any deduction allowed Chapter 1 of the Code for depreciation (or amortization in lieu of depreciation) with respect to the property acquired with such payment.[45]

3. Interest Expense Allocable to a Foreign Corporation's ECI

….

Finally, we believe that the approach taken in the Proposed Regulations with respect to treaty-based methods that attribute profit based on functions performed, assets used, and risks assumed can reach results that are punitive and are inconsistent with ordinary income tax principles. This section of the Proposed Regulations appears to be directed at treaty methods that follow the authorized OECD approach ("AOA") for the attribution of profits to permanent establishments, which give effect in some cases to "internal dealings" between the permanent establishment and the rest of the enterprise solely for purposes of attributing profits within the same legal entity. As noted in the Preamble, such an approach does not create legal obligations between the U.S. permanent establishment and the rest of the enterprise. While following the AOA may result in an interest deduction that is greater than the result of U.S. profit attribution rules, it does not in fact create intercompany deductions, and is instead better viewed as an alternative way of arriving at the total amount of excess interest that is deductible by the foreign corporation. We therefore recommend that where a taxpayer uses a treaty method that determines profit on the basis of the functions performed, assets used, and risks assumed, its interest deductions in excess of U.S.-booked liabilities should be treated in the same manner as interest on excess U.S.-connected liabilities. That is, we recommend that such amounts be treated as base erosion payments on a pro rata basis in accordance with the portion of the foreign corporation's overall borrowing that is from foreign related parties, rather than being treated as *per se* base erosion payments.

III. Detailed Discussion of Recommendations

C. Proposed Regulations Section 1.59A-3

7. Interest expense allocable to ECI

The Prior Report discussed the applicability of BEAT to the interest expense of a U.S. branch (or other activity related to ECI). In the Prior Report, we recommended that (1) regardless of whether the taxpayer uses the "adjusted U.S. booked liabilities" ("***AUSBL***") method or the "separate currency pools" method, interest expense on U.S.-booked liabilities ("***Branch Interest***") should be treated as paid to the branch's creditor for purposes of BEAT, and (2) the excess amount of a foreign corporation's interest allocated or apportioned to ECI under Treasury Regulations Section 1.882-5 over Branch Interest (such excess amount, "***Excess Interest***") should also be subject to BEAT to the extent that the foreign corporation has borrowed from a foreign related party.[49]

The Proposed Regulations generally provide that a foreign corporation that has interest expense allocable under Section 882(c) to ECI is treated as making a Base Erosion Payment to the extent that such interest expense results from a payment or accrual to a foreign related party.[50] We note, however, that there are several inconsistencies in the Proposed Regulations with respect to the allocation of interest expense to ECI.

a) Treaty allocations to a branch and excess interest

The treatment under the Proposed Regulations of interest expense allocable to ECI pursuant to the business profits provisions of an income tax treaty is inconsistent with the treatment under the Proposed Regulations of interest expense allocable to ECI under Treasury Regulations Section 1.882-5.

More specifically, where a foreign corporation determines the profits attributable to a permanent establishment based on the assets used, risks assumed and functions performed by the permanent establishment, the Proposed Regulations treat transactions between the permanent establishment and the home office or other branches of the foreign corporation (such transactions, "***Internal Dealings***") as being actually paid or accrued for purposes of determining whether there is a Base Erosion Payment.[51] Under Treasury Regulations Section 1.882-5(c)(2)(viii), on the other hand, transactions between separate offices or branches of the same taxpayer are ignored, and the allocation of interest expense for purposes of determining Base Erosion Payments is dependent on the foreign corporation's worldwide borrowings from related foreign parties.

The Preamble explains that the allocation of interest expense under Treasury Regulations Section 1.882-5 is distinct from Internal Dealings, because the former "represents a division of the expenses of the enterprise, rather than a payment between the branch or permanent establishment and the rest of the enterprise," while Internal Dealings "are priced on the basis of assets used, risks assumed, and functions performed by the permanent establishment in a manner consistent with the arm's length principle."[52]

We note that the arm's-length construct described above for characterizing Internal Dealings pursuant to an income tax treaty represents an attempt to fairly apportion the operating results of the U.S. permanent establishment and the home office or other branches of the foreign corporation. This goal is similar to the goal of the allocation rules under Treasury Regulations Section 1.882-5. By drawing a distinction between Internal Dealings and allocations pursuant to Treasury Regulations Section 1.882-5, the Proposed Regulations create a regime that could be more taxpayer-adverse under a treaty as compared with U.S. law in the absence of a treaty.[53] Treasury should consider this approach in light of treaty non-discrimination provisions and, in the case of a taxpayer applying both Internal Dealings and allocations under Treasury Regulations Section 1.882-5 for different businesses in the same year, in light of treaty consistency principles.[54]

[49]The Prior Report acknowledged that a literal reading of Section 59A(d) suggests that BEAT is inapplicable to Excess Interest, since the deduction for Excess Interest is notional and does not itself represent a payment or accrual to any person. *See* Prior Report at 27. The Prior Report, however, also recognizes that such a literal reading is not the only acceptable reading, given that Excess Interest is treated under the Treasury Regulations as an allocation or apportionment to ECI of a portion of the foreign corporation's third-party interest expense. *Id*.

[50]Proposed Regulations Section 1.59A-3(b)(4).

[51]Proposed Regulations Section 1.59A-3(b)(4)(v).

[52]Preamble at 65961.

[53]We acknowledge that the distinction drawn by the Proposed Regulations is arguably supported by the reasoning in *Nat'l Westminster Bank, PLC* v. *United States*, 512 F.3d 1347 (Fed. Cir. 2008), which interpreted the business profits provisions of the 1975 U.S.-U.K. income tax treaty as not "permitting transactions between the permanent establishment and the enterprise to be disregarded" and thus interpreted the treaty as taking a different approach from Treasury Regulations Section 1.882-5. *Id.* at 1354-55, 1359.

[54]*See* Revenue Ruling 84-17, 1984-1 C. B. 308; *see also* New York State Bar Association Tax Section Report No. 1325, Tax Treaty Consistency Principle (July 14, 2015).

IV.A.3.(c) Prop. Reg. § 1.59A-3(b)(4)(v)(B) violates U.S. income tax treaties

As discussed above, the AOA treats the PE as a separate entity solely for purposes of determining an appropriate profit attribution.

As explained by Treasury in its Technical Explanation to several U.S. income tax treaties, and recognized by Treasury and the Service themselves in the Preamble, such method of profits attribution "does not create legal obligations or other tax consequences that would result from transactions having independent legal significance."[97] Such treatment of the AOA given by Treasury is consistent with how the OECD has designed such method of profits attribution, *i.e.*, as being "relevant only for the attribution of profits to the PE under Article 7 and does not carry wider implications as regards, for example, withholding taxes,"[98] that is, for tax purposes. Therefore, by treating internal dealings as regarded transactions that may potentially give rise to base erosion payments, Prop. Reg. § 1.59A-3(b)(4)(v)(B) clearly violates the U.S. income tax treaties that have incorporated the AOA as a method of profit attribution under Article 7.

Moreover, under Article 7(1) of the U.S.-U.K. Treaty,[99] for example, if a foreign resident carries on business in the United States through a PE, the United States may impose tax on any "business profits" that are attributable to the PE. Article 7(3) of the U.S.-U.K. Treaty then provides that the business profits of a PE are determined with deductions for all expenses incurred for the purpose of the PE. In explaining such provision, the Department of Treasury Technical Explanation to the U.S.-U.K. Treaty provides that, under Article 7(3), "deductions shall be allowed for the expenses incurred for the purposes of the permanent establishment, *ensuring that business profits will be taxed on a net basis*" (emphasis added). Thus, the possible treatment of deductions from internal dealings as base erosion payments would violate Article 7(3) of the U.S.-U.K. Treaty (and other U.S. income tax treaties with a similar provision) to the extent that it could cause a foreign corporation to be taxed in an amount higher than the net business profits attributed to the U.S. PE.

Treaties are not given precedence over statutes because of their nature as treaties.[100] Under the Constitution, treaties rank, with federal laws, as the supreme law of the land.[101] Historically, though, absent specific legislative history or explicit statutory override, courts have upheld existing treaties that conflict with subsequent laws.[102] According to the Supreme Court, a "treaty will not be deemed to have been abrogated or modified by a later statute, unless such purpose on the part of Congress has been clearly expressed."[103] Therefore, if courts will not interpret a statute to abrogate a treaty without clear congressional intent, then regulations issued under such statute should also not be treated as overriding U.S. income tax treaties.

In enacting section 59A, though, Congress expressed no explicit intent to override U.S. income tax treaties, whether in the statute or in the legislative history.[104] Accordingly, because Prop. Reg. §1.59A-3(b)(4)(v)(B) contradicts U.S. income tax treaties without adequate statutory authority, internal dealings should be excluded from the definition of a base erosion payment.

[97]Treasury Department Technical Explanation to the 2006 U.S. Model Tax Treaty, Article 7.

[98]The 2010 OECD Report, Part IV, C-1(iii)(f), section 166.

[99]The Convention between the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed on July 24, 2001, as amended by a protocol signed on July 19, 2002, and as clarified by competent authority agreements dated April 11, 2005, October 6, 2006, and October 18, 2007 ("**U.S.-U.K. Treaty** ").

[100]Section 7852(d).

[101]U.S. Const. art. VI, cl. 2.

[102]*Cook v. United States*, 288 U.S. 102, 120 (1933). Applying this principle in cases involving treaty obligations, the Court has stated that "a treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed." *Trans World Airlines, Inc. v. Franklin Mint Corp.*, 466 U.S. 243, 252 (1984) (quoting *Cook v. United States*, 288 U.S. 102, 120 (1933)); *see also Washington v. Washington Commercial Passenger Fishing Vessel Ass'n*, 443 U.S. 658, 690 (1979) ("Absent explicit statutory language, we have been extremely reluctant to find congressional abrogation of treaty rights."); *Menominee Tribe of Indians v. United States*, 391 U.S. 404, 412-13 (1968) ("the intention to abrogate or modify a treaty is not to be lightly imputed to the Congress" (quoting Pigeon River Co. v. Cox Co., 291 U.S. 138, 160 (1934))). In *Trans World Airlines*, the Court relied on this principle to sustain its conclusion that the Warsaw Convention's cargo liability limit was enforceable in U.S. courts, notwithstanding subsequent acts of Congress that could reasonably have been interpreted to render that Convention unenforceable. *See Trans World Airlines*, 466 U.S. at 251-53.

[103]*Id*. (emphasis added); *see Estate of Burghardtv. Commissioner*, 80 T.C. 705, 717 (1983) (finding no congressional intent to abrogate provision of tax treaty).

[104]On the contrary, indicating Congress's intent not to override U.S. income tax treaties, Tom Barthold, Chief of Staff for the Joint Committee on Taxation, responded to a question from the then Ranking Member of the Senate Foreign Relations Committee about the interaction between the BEAT and the treaties in the Senate Committee on Finance's markup session, saying that "[The BEAT] is structured as an alternative tax compared to the income tax. So *I think our view is that there is not a treaty override inherent in that design*" (emphasis added). Open Executive Session to Consider an Original Bill Entitled the "Tax Cuts and Jobs Act" (Cont'n Nov. 14, 2017): Hearing on H.R. 1 Before the S. Comm. on Finance, 115th Cong. 163 (2017) (question from Sen. Benjamin L. Cardin, D-Md.).

Observations on the BEAT Proposed Regulations' Impact On Banks by Mike Gaffney and Danny Simon (TNI, March 18, 2019)

Treaty Approach

Although most foreign banks use domestic law under reg. section 1.882-5, some use a treaty-based approach to determine the profit or loss attributable to their U.S. PEs, and a subset of them have U.S. treaties that have been updated to include the AOA.[37] Interestingly, perhaps to maintain some parity with the foreign banks using reg. section 1.882-5, the proposed regulations may treat some internal dealings under a treaty as a base erosion payment. As we explain, however, the proposed rule goes too far.

The proposed regulations provide that when a foreign corporation determines the profits attributable to a PE by applying transfer pricing principles by analogy (under an applicable income tax treaty), any deduction attributable to any amount paid or accrued (or treated as paid or accrued) by the PE to the foreign corporation's home office or to another branch of the foreign corporation (an internal dealing) is treated as "regarded" for purposes of applying the BEAT and may therefore constitute a base erosion payment. This is even though treaty-based approaches to attributing profits to a PE recognize these internal dealings within a single legal entity only for profit attribution and do not create actual transactions or payments between related parties.

To put it mildly, recognizing these internal dealings as base erosion payments runs counter to basic fundamental U.S. tax principles. See, for example, the preamble to the proposed GD regulations under which Treasury previously specified that "consistent with U.S. tax principles . . . an agreement between two [qualified business units] of a single taxpayer does not give rise to a transaction because a taxpayer cannot enter into nor profit from a 'transaction' with itself." Treaty-based approaches *allocate* income and expense items among different qualified business units of the same entity — they don't create fictitious transactions between branches or between a branch and its head office. We believe that if a treaty-based approach allocates an amount from a head office to the U.S. branch and that amount is the result of the corporation paying or accruing an amount to a foreign related party, this should be a base erosion payment. However, it is a mistake in tax policy and practice to consider all internal dealing amounts from tax treaties as base erosion payments.

23/ The U.S. treaties with Belgium, Bulgaria, Canada, Germany, Iceland, Japan, and the United Kingdom have been updated to include the AOA. For a description of the approach, see 2010 AOA, *supra* note 23.

USCIB Comment Letter on Prop Reg 59A (Feb. 19, 2019)

I.I. Deductions from Internal Dealings allowed in Computing Business Profits of the PE

Under § **1.59A-3(b)(4)(v)(B)** of the proposed regulations, “deductions” from internal dealings allowed in computing business profits of a U.S. permanent establishment (“PE”) are treated as base eroding payments to the extent they would be so treated under § 1.59A-3(b)(1). The proposed regulations conflict with the Authorized OECD Approach (“AOA”) with respect to internal dealings. Internal dealings are only relevant for the purposes of determining the profit of the permanent establishment and are not otherwise recognized.[3] The United States has been a supporter of the AOA[4] and that approach has been subject to question by other countries, including countries that would like to recognize those dealings for purposes of imposing withholding taxes. Extending the BEAT to internal dealings would lend support to those positions. USCIB, therefore, recommends that the final regulations reverse the decision of the proposed regulations and exclude internal dealings from treatment as a BEAT payment.

[3] OECD 2010 Report on the Attribution of Profits to Permanent Establishments, July 22, 2010, Part 1, B-2, section 11, at page 13.

[4] Treasury Department Technical Explanation to the 2006 U.S. Model Tax Treaty, Article 7. Page 23, “. . . . the use of the Transfer Pricing Guidelines applies only for purposes of attributing profits within the legal entity. It does not create legal obligations or other tax consequences that would result from transactions having independent legal significance.” Although the U.S. Treasury has issued a new U.S. Model Income Tax Treaty and Preamble in 2016, the Treasury did not issue a new Model Technical Explanation.

Silicon Valley Tax Directors Group Comments on Prop Regs. 59A (Feb. 19, 2019)

I.B.[B] The rule in Prop. § 1.59A-3(b)(4)(v) deeming base erosion payments in the context of a U.S. PE exceeds the authority of Treasury and the IRS

Clause **1.59A-3(b)(4)(v)(B)** provides that if, under an income tax treaty, a foreign corporation determines profits attributable to a U.S. PE based on assets used, risks assumed, and functions performed by such PE, then "any deduction attributable to any amount paid or accrued (or treated as paid or accrued)" by the PE either to the foreign corporation home office or to another branch of the foreign corporation — a so-called "internal dealing" — is a base erosion payment to the extent it meets the general requirements for a base erosion payment. We believe the rule in Prop. § 1.59A-3(b)(4)(v) exceeds the authority of Treasury and the IRS under § 59A, because it's contrary to § 59A(d)(1). We accordingly recommend it be withdrawn.

II.B

B. The rule in Prop. § 1.59A-3(b)(4)(v) deeming base erosion payments in the context of a U.S. PE exceeds the authority of Treasury and the IRS

Clause **1.59A-3(b)(4)(v)(B)** provides that if, under an income tax treaty, a foreign corporation determined profits attributable to a U.S. PE based on assets used, risks assumed, and functions performed by such PE, then "any deduction attributable to any amount paid or accrued (or treated as paid or accrued)" by the PE either to the foreign corporation home office or to another branch of the foreign corporation — a so-called "internal dealing" — is a base erosion payment to the extent it meets the general requirements for a base erosion payment in Prop. § 1.59A-3(b)(1). Clause 1.59A-3(b)(4)(v)(A) has a parallel but more complex rule applicable in certain situations if a foreign corporation elects to determine its taxable income using "business profits" provisions of an income tax treaty for determining ECI.

We believe the rule in Prop. § 1.59A-3(b)(4)(v) exceeds the authority of Treasury and the IRS under § 59A.

Paragraph 59A(d)(1) defines a base erosion payment generally as any amount "paid or accrued" by the taxpayer to "a foreign person [that] is a related party of the taxpayer," if a deduction is allowable with respect to such amount. An "internal dealing" doesn't involve an actual payment — it's a construct whose existence is inferred solely for determining an arm's length attribution of profit to a PE.[4] Clause 1.59A-3(b)(4)(v)(A) refers to "any amount paid or accrued (or treated as paid or accrued) by the [PE] . . ." (emphasis added) but a base erosion payment only arises under § 59A(d)(1) if any amount is actually "paid or accrued." In creating the *TCJA*, Congress wrote tax statutes using the parenthetical "(or treated as paid or accrued)" if it intended that deemed amounts paid or accrued also — i.e., in addition to actual amounts paid or accrued — be included in a provision.[5] But Congress didn't use that language in § 59A(d)(1), and this means Congress didn't intend deemed amounts paid or accrued to give rise to base erosion payments.[6]

Paragraph 59A(d)(1) also requires a base erosion payment be made to a foreign person that's a related party to the taxpayer. The requirement that the recipient of a base erosion payment be an actual related foreign person isn't met by a payment arising from an internal dealing because such payment is, of course, purely internal — within the same entity: the foreign corporation with a sufficiently extant U.S. taxable presence.

Because the rule in Prop. § 1.59A-3(b)(4)(v) is contrary to § 59A(d)(1), we recommend it should be withdrawn.

[4]OECD, *2010 Report on the Attribution of Profits to a Permanent Establishment*, ¶ 176. The same document explained (¶ 203), using the example of a notional royalty payment, that "[t]he recognition of the notional royalty is relevant only to the attribution of profits to the PE under Article 7 and should not be understood to carry wider implications as regards withholding taxes. . . ." By parity of reasoning, notional payments arising from internal dealings shouldn't be treated as base erosion payments.

[5]*See, e.g.*, § 245A(d)(1) (referring to "taxes paid or accrued (or treated as paid or accrued)") and § 965(g)(1) (likewise).

[6]*See, e.g.*, *Barnhart v. Simon Coal Co., Inc.*, 534 U.S. 438, 461–462 ("We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there." (citations omitted)).

COMMENTS BY ALLIANCE FOR COMPETITIVE TAXATION ON PROPOSED REGULATIONS IMPLEMENTING SECTION 59A (Feb 19, 2019)

II. A. 1. Internal dealings of a treaty-eligible entity (Prop. Reg. § 1.59A-3(b)(4)(v)(B))

Proposed Regulations

Prop. Reg. § 1.59A-3(b)(4)(v)(B) provides:

If, pursuant to the terms of an applicable income tax treaty, a foreign corporation determines the profits attributable to a permanent establishment based on the assets used, risks assumed, and functions performed by the permanent establishment, then any deduction attributable to any amount paid or accrued (or treated as paid or accrued) by the permanent establishment to the foreign corporation's home office or to another branch of the foreign corporation (an "internal dealing") is a base erosion payment to the extent such payment or accrual is described under [Prop. Reg. § 1.59A-3(b)(1)].

Treasury Explanation

The preamble states that the approach in the Proposed Regulations is intended to create parity between deductions for actual regarded payments between two separate corporations (which are subject to section 482) and internal dealings (which are generally priced in a manner consistent with the applicable treaty and, if applicable, the OECD Transfer Pricing Guidelines).[1]

ACT Recommendation

ACT recommends that internal dealings be excluded from the definition of base erosion payments.

Reasons for ACT Recommendation

The method of attributing profits to a permanent establishment ("PE") under an applicable income tax treaty referenced by Prop. Reg. § 1.59A-3(b)(4)(v)(B) is commonly referred to as the Authorized OECD Approach ("AOA"). However, because under U.S. federal income tax rules, internal dealings within a single corporation are generally disregarded, the AOA is limited to the specific purpose of attributing profits to a PE.[2] The OECD 2010 Report on the Attribution of Profits to Permanent Establishments (the "2010 OECD Report") emphasizes the limited application of the AOA:[3]

The hypothesis by which a PE is treated as a functionally separate and independent enterprise is ***a mere fiction necessary for purposes of determining the business profits of this part of the enterprise under Article 7***. The authorised OECD approach should not be viewed as implying that the PE must be treated as a separate enterprise entering into dealings with the rest of the enterprise of which it is a part ***for purposes of any other provisions of the Convention***. (. . .)

In this context, it should be noted that ***the aim of the authorised OECD approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits*** but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. (Emphasis added.)

The 2010 OECD Report reiterates that recognizing internal dealings "does not carry wider implications as regards, for example, withholding taxes."[4]

Similarly, the U.S. Treasury Technical Explanation to the 2006 U.S. Model Tax Treaty provides:[5]

[A]ny of the methods used in the Transfer Pricing Guidelines, including profits methods, may be used as appropriate and in accordance with the Transfer Pricing Guidelines. However, the use of the Transfer Pricing Guidelines ***applies only for purposes of attributing profits within the legal entity. It does not create legal obligations or other tax consequences that would result from transactions having independent legal significance***. (Emphasis added.)

Regulations under other provisions of the Code generally do not recognize internal dealings within a single corporation or taxpayer. Under Prop. Reg. § 1.863-3(h)(3)(iii), for example, "[a]n agreement among QBUs of the same taxpayer to allocate income, gain or loss from transactions with third parties is not a transaction because a taxpayer cannot enter into a contract with itself."[6] Similarly, under Treas. Reg. § 1.882-5, interbranch transactions of any type between separate offices or branches of the same taxpayer do not result in the creation of an asset or a liability.[7] Further, under Treas. Reg. § 1.1503(d)-5(c)(1)(ii), items of income, gain, deduction, and loss that are otherwise disregarded for U.S. tax purposes are not taken into account for determining the income or dual consolidated loss attributable to a separate unit.[8]

Accordingly, treating internal dealings as base erosion payments for BEAT purposes is inconsistent with the limited application of the AOA and contrary to the general U.S. tax principle of disregarding intra-taxpayer transactions.

Moreover, BEAT only applies if there is an amount "paid or accrued."[9] Internal dealings, on the other hand, are fictional transactions created for the mere purpose of determining business profits attributable to a PE, and as such, do not produce any payment or accrual. Nothing in section 59A suggests that a base erosion payment may include an amount "deemed" paid or accrued or "treated as" paid or accrued. Subjecting to section 59A hypothetical transactions that do not actually exist is inconsistent with the statutory language of section 59A.

Further, imposing U.S. tax on account of internal dealings under section 59A violates the U.S. income tax treaties that have incorporated the AOA under the business profits article. This is because taxing amounts treated as paid by a U.S. PE to the home office under section 59A conflicts with the treaty exemption from U.S. taxation of these amounts.[10] Absent explicit legislative history or statutory override, existing treaties generally are not abrogated by subsequent laws that come into conflict.[11] In enacting section 59A, Congress expressed no intent to override U.S. income tax treaties.[12]

For the above reasons, ACT recommends that internal dealings (within the meaning of Prop. Reg. § 1.59A-3(b)(4)(v)(B)) be excluded from the definition of base erosion payments.

Regulatory Authority for Recommendation

Treasury has authority under section 59A(i) to "prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of [section 59A]." In addition, Treasury has the authority to adopt "all needful rules and regulations" under section 7805(a).

[2]*See*, *e.g.*, Department of the Treasury Technical Explanation to the U.S.-U.K. Tax Treaty, Art. 7.

[3]OECD 2010 Report on the Attribution of Profits to Permanent Establishments, Part 1, B-2, Section 11, July 22, 2010, www.oecd.org/ctp/transfer-pricing/45689524.pdf.

[4]The 2010 OECD Report, Part IV, C-1(iii)(f), section 166.

[5]Treasury Department Technical Explanation to the 2006 U.S. Model Tax Treaty, Art. 7. No substantive changes were made to Article 7 of the subsequent 2016 U.S. Model Tax Treaty that would affect the above Technical Explanation.

[6]*See also* Treas. Reg. § 1.446-3(c)(1)(i) ("An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract because a taxpayer cannot enter into a contract with itself.").

[7]*See* Treas. Reg. §§ 1.882-5(b)(1)(iv) and (c)(2)(viii).

[8]*See* Treas. Reg. § 1.1503(d)-7(c) Example 23.

[9]*See* section 59A(d).

[10]*See, e.g.*, Convention between the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed on July 24, 2001, as amended by a protocol signed on July 19, 2002, and as clarified by competent authority agreements dated April 11, 2005, October 6, 2006, and October 18, 2007 (the "U.S.-U.K. Treaty"), Art. 7(1).

[11]*Cook v. United States*, 288 U.S. 102, 120 (1933). Applying this principle in cases involving treaty obligations, the Court has stated that "a treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed." *Trans World Airlines, Inc. v. Franklin Mint Corp.*, 466 U.S. 243, 252 (1984) (quoting *Cook v. United States*, 288 U.S. 102, 120 (1933)); *see also Washington v. Washington Commercial Passenger Fishing Vessel Ass'n*, 443 U.S. 658, 690 (1979) ("Absent explicit statutory language, we have been extremely reluctant to find congressional abrogation of treaty rights."); *Menominee Tribe of Indians v. United States*, 391 U.S. 404, 412-13 (1968) ("the intention to abrogate or modify a treaty is not to be lightly imputed to the Congress" (quoting *Pigeon River Co. v. Cox Co.*, 291 U.S. 138, 160 (1934)).

[12]Congress had historically acknowledged that absent explicit override, treaties are given the regard which it is due under the ordinary rule of interpreting the interactions of statutes and treaties. *See* Technical and Miscellaneous Revenue Act of 1988, H.R. 4333, 100th Cong. § 2 (1988) ("[W]here a treaty obligation calls for a certain tax result with respect to a particular item of income (whether that result is to exempt that item of tax or reduce the rate of U.S. tax on that item), that result differs from the result called for under a Code provision, and that treaty obligation has not been superseded for internal U.S. law purposes, the agreement acknowledges that taxpayers and the IRS can look beyond the Code to determine the proper tax treatment of the item of income in question.").

<u>Materials Relating to Act III Bar Room Brawl Over Digital Taxes</u>

European Commission, Council Directive COM(2018) 148 final *Excerpt*

Proposal for a

COUNCIL DIRECTIVE

on the common system of a digital services tax on revenues resulting from the provision of certain digital services

Brussels, 21.3.2018

<u>EXPLANATORY MEMORANDUM</u>

1. CONTEXT OF THE PROPOSAL

Reasons for and objectives of the proposal

The Digital Single Market is one of the main political priorities of the European Commission[1], which aims at opening up digital opportunities for people and businesses in a market of over 500 million EU consumers. In order to deliver on its potential, the Digital Single Market needs a modern and stable tax framework which stimulates innovation, tackles market fragmentation and allows all players to tap into the new market dynamics under fair and balanced conditions. Ensuring fair taxation of the digital economy is also part of the European Commission's agenda on a fair and efficient tax system in the European Union[2].

The digital economy is transforming the way we interact, consume and do business. Digital companies are growing far faster than the economy at large, and this trend is only set to continue. Digital technologies bring many benefits to society and, from a tax perspective, they create opportunities for tax administrations and offer solutions to reduce administrative burdens, facilitate collaboration between tax authorities, as well as addressing tax evasion.

However, policy makers are currently struggling to find solutions which can ensure a fair and effective taxation as the digital transformation of the economy accelerates, given that the existing corporate taxation rules are outdated and do not capture this evolution. In particular, the current rules no longer fit the present context where online trading across borders with no physical presence has been facilitated, where businesses largely rely on hard-to-value intangible assets, and where user generated contents and data collection have become core activities for the value creation of digital businesses.

At the international level, the Organisation for Economic Co-operation and Development (OECD) already recognised, in its Action 1 report[3] which was released in 2015 as part of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project, that digitalisation and some of the resulting business models present challenges for international taxation. Following that report, the G20 Finance Ministers reiterated their support for the OECD's work on taxation and digitalisation. Hence, the OECD has been working on an interim report[4] on the taxation of the digital economy which was presented to the G20 Finance Ministers in March 2018. The interim report examines the need to adapt the international tax system to the digitalisation of the economy and identifies the elements to be taken into account by those countries wishing to introduce interim measures to address the tax challenges arising from digitalisation.

At Union level, such challenges were identified in the Communication of the Commission "A Fair and Efficient Tax System in the European Union for the Digital Single Market"[5], adopted on 21 September 2017. The current initiative was also mentioned in President Juncker's letter of intent accompanying the State of the Union Address 2017[6]. As regards Member States, several EU Finance Ministers co-signed a political statement ("Joint initiative on the taxation of companies operating in the digital economy") that supported EU law compatible and effective solutions "based on the concept of establishing a so-called 'equalisation tax' on the turnover generated in Europe by the digital companies"[7]. This was followed by the conclusions adopted on 19 October 2017 by the European Council[8] that underlined the "*need for an effective and fair taxation system fit for the digital era*". Furthermore, the ECOFIN Council Conclusions of 5 December 2017[9] noted the interest of many Member States for temporary measures, such as a levy based on revenues from digital activities in the Union, and considered that these measures could be assessed by the Commission.

This proposal answers these calls for action, and addresses in an interim way the problem that the current corporate tax rules are inadequate for the digital economy.

The current corporate tax rules were conceived for traditional businesses. The existing tax rules are built on the principle that profits should be taxed where the value is created. However, they were mainly conceived in the early 20th century for traditional "brick and mortar" businesses and define what triggers a right to tax in a country (where to tax) and how much of corporate income is allocated to a country (how much to tax) largely based on having a physical presence in that country. That means that non-tax residents become liable to tax in a country only if they have a presence that amounts to a permanent establishment there. However, such rules fail to capture the global reach of digital activities where physical presence is not a requirement anymore in order to be able to supply digital services. Moreover, digital business have different characteristics than traditional ones in terms of how value is created, due to their ability to conduct activities remotely, the contribution of end-users in their value creation, the importance of intangible assets, as well as a tendency towards winner-takes-most market structures rooted in the strong presence of network effects and the value of big data.

The application of the current corporate tax rules to the digital economy has led to a misalignment between the place where the profits are taxed and the place where value is created, notably in the case of business models heavily reliant on user participation. This poses a double challenge from a tax perspective. Firstly, the input obtained by a business from users, which actually constitutes the creation of value for the company, could be located in a tax jurisdiction where the company carrying out a digital activity is not physically established (and thus not established for tax purposes according to the current rules) and where therefore the profits generated from such activities cannot be taxed. Secondly, even where a company has a permanent establishment in the jurisdiction where the users are located, the value created by user participation is not taken into account when deciding how much tax should be paid in each country. This has also consequences from the perspective of the risk to artificially avoid permanent establishment rules, creates distortion of competition between digital market players, and has a negative impact on revenues.

The Commission has acknowledged that the ideal approach would be to find multilateral, international solutions to taxing the digital economy given the global nature of this challenge. The Commission is working closely with the OECD to support the development of an international solution. However, progress at international level is challenging, due to the complex nature of the problem and the wide variety of issues that need to be addressed, and reaching international consensus may take time. This is why the Commission has decided to take action and is proposing today to adapt the corporate tax rules at Union level so that they are fit for the characteristics of digital businesses[10] and to recommend that Member States extend this comprehensive solution to their double taxation treaties with non-Union jurisdictions[11]. Whilst the ECOFIN Council also stressed in its conclusions of 5 December 2017 its preference for a global solution endeavouring to closely monitor future international developments and consider appropriate responses, it welcomed EU action. Despite the present proposals, work at the OECD level is essential in order to reach a global consensus on this topic. The Commission will closely follow the developments.

In the wait of the comprehensive solution, which may take time to adopt and implement, Member States face pressure to act on this issue, given the risk that their corporate tax bases are significantly eroded over time, and also due to the perceived unfairness of the situation. While unilateral measures are in place or are concretely planned in 10 Member States for addressing this problem in a limited way, the trend has been increasing and the measures adopted are very diverse in terms of scope and their rationale. Such uncoordinated measures taken by Member States individually risk further fragmenting the Single Market and distort competition, hampering the development of new digital solutions and the Union's competitiveness as a whole.

Hence, it is necessary for the Commission to act and to propose a harmonised approach on an interim solution that tackles this problem in a targeted way. To this extent, this proposal sets out the common system of a tax on the revenues derived from the supply of certain digital services by taxable persons (hereinafter "Digital Services Tax" or "DST"). The specific objective of this proposal is to put forward a measure that targets the revenues stemming from the supply of certain digital services and that is easy to implement and helps to level the playing field in the interim period until a comprehensive solution is in place.

This is in line with the general objectives of this proposal, whose aim is:

- to protect the integrity of the Single Market and to ensure its proper functioning;

- to make sure that the public finances within the Union are sustainable and that the national tax bases are not eroded;

- to ensure that social fairness is preserved and that there is a level playing field for all businesses operating in the Union; and

- to fight against aggressive tax planning and to close the gaps that currently exist in the international rules which makes it possible for some digital companies to escape taxation in countries where they operate and create value.

Consistency with existing policy provisions in the policy area

This proposal is part of the efforts being undertaken at Union and international level in order to adapt the current tax framework to the digital economy.

At international level, the challenge of ensuring that all actors in the digital economy are fairly taxed on their income was already identified under the Action 1 of the OECD/G20 BEPS project and the OECD has been working on an interim report on the taxation of the digital economy which was presented to the G20 Finance Ministers in March 2018.

At Union level, fair tax rules for the taxation of the digital economy are part of the Commission's fair taxation agenda, which will complement the improvements of the corporate tax framework achieved in recent years. In this respect, the Commission relaunched in 2016 the proposal on a Common Consolidated Corporate Tax Base (CCCTB)[12], which will provide a competitive, fair and robust framework for taxing companies in the Single Market. In the area of VAT, the Commission is also addressing the challenges posed by the digital economy with its proposal on e-commerce which the Council adopted in December 2017[13], which is in line with other legislative measures laid down in the 2016 Action Plan on VAT[14].

This proposal is part of a package which also includes a proposal for a Directive on a comprehensive solution[15], a Recommendation to Member States to reflect the comprehensive solution in their double taxation treaties with non-Union jurisdictions[16] and a Communication setting the context and explaining the articulation between the proposals[17]. The principles underpinning this proposal and, in particular, the notion of user value creation are aligned with the proposal for a Directive on a comprehensive solution and the Recommendation, as explained in the Communication. Notably, this interim measure covers those cases where the contribution of users to the creation of value for a company is more significant, while the concept of user value creation is also the factor which the comprehensive solution aims to reflect in the corporate tax framework.

Consistency with other Union policies

This proposal is also consistent with the Digital Single Market strategy[18], where the Commission committed to ensure access to online activities for individuals and businesses under conditions of fair competition, as well as to open up digital opportunities for people and business and enhance Europe's position as a world leader in the digital economy.

2. LEGAL BASIS, SUBSIDIARITY AND PROPORTIONALITY

Legal basis

The proposed Directive is based on Article 113 of the Treaty on the Functioning of the European Union (TFEU). This provision enables the Council, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the European Economic and Social Committee, to adopt provisions for the harmonisation of Member States' legislation concerning other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition.

Subsidiarity (for non-exclusive competence)

The proposal is consistent with the principle of subsidiarity as set out in Article 5(3) of the Treaty on European Union (TEU). In the wait of a common and coordinated action at Union level to reform the corporate tax framework to cover the digital activities of companies, Member States may introduce unilateral interim measures to address the challenges of taxing the digital economy companies. Some of such measures, which can be of a very diverse nature, are already in place or are being planned by Member States. In this respect, EU action is necessary in order to mitigate the fragmentation of the Single Market and the creation of distortions of competition within the Union due to the adoption of such divergent unilateral actions at national level. Moreover, an EU solution rather than different national policies entails a reduction in the compliance burden for businesses subject to the new rules, and also gives a strong sign to the international community as to the commitment of the EU to act when it comes to ensuring the fair taxation of the digital economy.

Proportionality

The preferred option is consistent with the principle of proportionality, that is, it does not go beyond what is necessary to meet the objectives of the Treaties, in particular the smooth functioning of the Single Market. As follows from the subsidiarity test, it is not possible for Member States to address the problem without hampering the Single Market. Moreover, the present proposal aims at setting a common structure of the tax, while leaving sufficient margin of manoeuvre for Member States when it comes to actual setting of certain administrative aspects related to the measure, such as accounting, record-keeping and other obligations intended to ensure that the DST due is effectively paid. Member States can also adopt measures concerning the prevention of evasion, avoidance and abuse with respect to DST, and they retain the capacity to enforce payment of DST and to carry out tax audits according to their own rules and procedures. See also section 9.4.2 of the impact assessment accompanying this proposal[19].

Choice of the instrument

A Directive is proposed, which is the only available instrument under Article 113 of the TFEU.

House Ways and Means, Senate Finance Leaders' Statement on Unilateral Digital Services Taxes, OECD Negotiations to Address the Tax Challenges of the Digitalization of the Economy

APRIL 10, 2019 — PRESS RELEASES

Washington, D.C. – Today, the top Republican on the House Ways and Means Committee Kevin Brady (R-TX), Senate Finance Committee Chairman Chuck Grassley (R-IA), House Ways and Means Committee Chairman Richard Neal (D-MA), and Senate Finance Committee Ranking Member Ron Wyden (D-OR) released the following statement:

"The tax challenges that have arisen due to digitalization of the economy affect businesses headquartered all over the world, and solutions to these challenges are best negotiated multilaterally. We are supportive of the United States participating in the ongoing OECD negotiations on these solutions. We call on other countries to focus on and engage productively in the OECD dialogue in order to reach measured and comprehensive solutions, and abandon unilateral measures. Even on an interim basis, unilateral actions, such as digital services taxes proposed by some countries, can adversely affect U.S. businesses and have negative economic and diplomatic effects.

"We look forward to engaging with the Treasury Department throughout this process and evaluating the outcome of the OECD's work and its impact on U.S. taxpayers and the U.S. treasury."

Background: Under the OECD/G-20 Inclusive Framework on base erosion and profit shifting (BEPS), over 125 countries are currently negotiating solutions to address the tax challenges of the digitalization of the economy. The G-20 finance ministers and other senior government representatives are meeting in Washington this week. The French National Assembly passed a unilateral digital services tax that would disproportionately affect U.S. technology companies. The law is expected to be taken up by the French Senate soon.

Rep. Brady has been a leader in pushing back on various digital tax proposals from foreign countries, fighting for U.S. companies to not be subject to double taxation from this blatant revenue grab.

LaHood Leads Effort to Combat Discriminatory Tax Proposals Targeting U.S. Businesses

WASHINGTON, D.C. — Congressman Darin LaHood (R-IL) led a letter to President Donald Trump urging his administration use all appropriate tools to address France and other European countries proposed digital services tax that targets US companies, US exports, and the US tax base. Rep. LaHood was joined by 15 Republicans on the Ways and Means Committee.

“Proposals by the French and other countries designed to explicitly target US companies through a digital services tax is wholly unacceptable and the US should be prepared to use any necessary tools to combat these actions,” **stated Rep. LaHood.** “Efforts by the French and others contradict longstanding global consensus-based practices and would result in double taxation on American businesses. We cannot sit on the sidelines as countries attempt to fund their governments by seizing the revenue of American businesses. I am proud to lead this effort and I urge President Trump and his Administration to forcefully engage on this issue, making it known that these types of practices won't stand.”

The Digital Services Tax

Across Europe, countries are proposing discriminatory three to five percent revenue taxes on digital services U.S. technology firms provide. These Digital Service Taxes (DST) are narrow in scope and are specifically designed to target U.S. digital companies that export services into European countries. These proposals directly contradict the international trade commitments made by the European Union and the global consensus-based Organization for Economic Cooperation and Development (OECD) process.

France's Proposal

In March of 2019, the French government proposed a unilateral DST on digital advertising, online platforms, and the transfer of data specifically aimed at U.S. technology companies. Under the proposal, U.S. companies could be charged up to 5 percent on gross revenue and it would be enacted retroactively to January 1, 2019. The French have made it explicitly clear that this proposal is designed for the purpose of going after American businesses and Finance Minister Lemaire has indicated this will raise the French over 500 million euros.

Beyond Europe, the World is Keenly Watching

The French proposal comes on the heels of the European Union's decision late last year to reject new revenue taxes narrowly targeted at U.S. digital companies. In addition, Germany, the United Kingdom, Italy, Spain, and Austria have proposed implementing similar digital service taxes. As European countries consider these discriminatory actions, the global community is looking on and preparing to follow the lead of others in targeting U.S. tech companies. American businesses shouldn't have their revenue seized to subsidize governments around the world and the U.S. should be prepared to engage on this issue.

April 3, 2019

President Donald J. Trump
The White House
1600 Pennsylvania Ave. NW
Washington, DC 20500

Dear Mr. President,

We are writing to express our serious concern regarding France's proposed digital services tax that targets US companies, US exports, and the US tax base. We urge you and your Administration to use all appropriate tools to address this issue.

On March 6, the French Government proposed a digital services tax that is designed and explicitly intended to target US companies. It sets a narrow definition of the types of services subject to tax, as well as specific revenue thresholds, that together ensure that US companies are the main taxpayers. Indeed, France's Finance Minister has been explicit about his intent to target US companies with this tax. Finally, to make matters worse, France proposes to make this tax retroactive to January 1 and to apply it to revenues, not profits. Other trading partners in Europe and elsewhere are considering similar discriminatory taxes, compounding the problem.

You have outlined a vision of negotiating zero tariffs, zero non-tariff barriers and zero subsidies in transatlantic trade, and we strongly agree with this objective. Yet as leading trade experts have noted, such a digital tax is discriminatory and operates like a “de facto” tariff on US exports and represents a move in exactly the wrong direction.

In addition to being an unfair trade barrier, France's digital services tax threatens the US tax base. The French Government asserts that US companies should be paying more tax in France and less tax in the US. The appropriate allocation of taxing rights is an issue that France should not dictate to the US through unfair trade actions. Instead, governments need to agree on common principles, work that Secretary Mnuchin has been ably leading at the OECD. France is looking to claim EUR500 million per year, the UK has passed similar legislation due to take effect next year, and other countries have said they will follow suit. We cannot sit by while these countries fund their government spending by seizing revenue that does not belong to them.

France, the UK, and other countries should immediately cease any unilateral actions that target US companies and instead focus their energy and efforts on the multilateral solutions that are being developed at the OECD. We urge your Administration to engage forcefully on these issues, including addressing them as a trade barrier.

Sincerely,

Darin LaHood
Member of Congress

Vern Buchanan
Member of Congress

Kenny Marchant
Member of Congress

Mike Kelly
Member of Congress

Jason Smith
Member of Congress

David Schweikert
Member of Congress

Brad Wenstrup
Member of Congress

A. Drew Ferguson, IV DMD
Member of Congress

Devin Nunes
Member of Congress

Adrian Smith
Member of Congress

Tom Reed
Member of Congress

George Holding
Member of Congress

Tom Rice
Member of Congress

Jackie Walorski
Member of Congress

Jodey Arrington
Member of Congress

Ron Estes
Member of Congress

CC:
The Honorable Steven Mnuchin, Secretary of the Treasury
Ambassador Lighthizer, United States Trade Representative

U.S. Senate Finance Leaders Ask Mnuchin to Weigh In on Digital Services Taxes

January 29, 2019

The Honorable Steven T. Mnuchin
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Mnuchin:

We write to express our serious concern regarding unilateral action by foreign countries to establish digital services taxes designed to discriminate against U.S.-based multinational companies. It is important that you make clear to the representatives of these countries the need to abandon unilateral actions and work through the multilateral process at the Organisation for Economic Co-operation and Development (OECD). We support your active participation in this multilateral process.

In October 2018, then-Senate Finance Committee Chairman Orrin Hatch and Ranking Member Ron Wyden sent a letter to the Presidents of the European Council and the European Commission expressing strong concerns about the European Commission's proposal to enact a discriminatory and indefinite digital services tax targeted at certain U.S.-based multinational companies, under the guise of addressing some of the challenges arising from deployment by multinational companies of digital business models and new technologies across the global economy. The letter called on the European Council and European Commission to abandon this proposal and on member states to delay implementing unilateral measures similar to the digital services tax. Further, the letter recommended that countries work within the OECD to reach consensus on a multilateral solution to these issues.

As the current Chairman and Ranking Member of the Senate Finance Committee, we reiterate those sentiments and the need for a multilateral solution that is fair, does not discriminate against certain U.S.-based multinational companies, does not create a new transatlantic barrier to trade, and avoids double taxation. We agree with your view on the need for our OECD partners to complete the multilateral process and avoid taking unilateral actions.

Unfortunately, some countries are moving forward unilaterally with digital services taxes that follow similar frameworks as the previous European Commission proposal. It is important for these countries to understand the potential for long-term harm arising under these proposals and the need for each to refocus efforts on reaching multilateral consensus. The release of the OECD's Policy Note today shows the process is moving forward, and unilateral action will only serve to undercut that progress.

We are supportive of the United States Treasury Department's active participation in the ongoing negotiations at the OECD regarding these new tax challenges. We urge you and your OECD counterparts to work expeditiously to achieve agreement on a measured and comprehensive approach to how international tax rules might be crafted to address such challenges.

Given that the Senate Finance Committee has jurisdiction over U.S. laws governing cross-border tax and trade matters, we strongly encourage you and your staff to stay in close contact with us and our staff as negotiations progress and multilateral solutions are developed.

We appreciate your efforts on these matters.

Sincerely,

Charles E. Grassley
Chairman
U.S. Senate Committee on Finance

Ron Wyden
Ranking Member
U.S. Senate Committee on Finance

cc:
Robert E. Lighthizer, United States Trade Representative

Attachment:
Letter to The Honorable Donald Tusk, President of the European Council, and The Honorable Jean-Claude Juncker, President of the European Commission, October 18, 2018