INTERNATIONAL CHAMBER OF COMMERCE
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Department of Policy and Business Practices

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By Email: lennard@un.org

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Subject: ICC's perspectives on the taxation of hybrid entities

Dear Mr. Lennard,

During the Eighth Session of the UN Committee of Experts on International Cooperation in Tax Matters (the "UN Committee"), the International Chamber of Commerce ("ICC") was asked to provide its views on the taxation of hybrid entities. ICC, as the world business organization, values the opportunity to engage in an on-going constructive dialogue with the UN Committee and is pleased to respond to the Committee's request for the provision of the wider business' perspective.

The treatment of hybrid entities in the international tax environment is rooted in the independent classification of entities according to the domestic laws of states. If one state classifies a particular entity as opaque, i.e. an independent income taxpayer, whilst another state classifies such entity as transparent, i.e. looks through such entity for income tax purposes, many issues arise from a tax treaty, domestic tax and tax policy perspective. An attempt to address the tax treaty issues for a specific group of hybrid entities was published in the 1999 Organization for Economic Cooperation and Development (OECD) Partnership Report. The tax treaty, domestic tax and tax policy issues associated with hybrid entities are currently also part of the OECD's Base Erosion and Profit Shifting (BEPS) project mandated by the G20. The OECD and G20, aim to make changes to the OECD Model Tax Convention and issue recommendations regarding the design of domestic rules quickly. Therefore, ICC would applaud increased synergy between the UN Committee and the work currently conducted by the OECD and encourages the UN Committee to feed the views of non-G20, non-OECD members into the OECD's BEPS project.

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ICC will discuss what it considers the most prominent issues pertaining to hybrid entities in Section 1 below. Subsequently, the possible approaches to deal with these issues and their pros and cons are presented in Section 2. Lastly, ICC's views on the taxation of hybrid entities will be explained in Section 3.

1. Issues pertaining to hybrid entities

The different classification of entities according to the domestic laws of states as well as differences in qualification of income items resulting from such different classification, form the heart of the discussion on hybrid entities. The classification of entities as transparent or non-transparent has its effects on the application of tax treaties to hybrid entities from two perspectives: that of the source state and the residence state. On the one hand, it is about double taxation and on the other hand, about tax arbitrage.

Double taxation emerges if either a hybrid entity, or its shareholders, is inappropriately denied tax treaty benefits, be it through a denial of tax treaty access or a denial of relief for double taxation.

Such double taxation can, amongst others, take the form of:

a) The levy of higher domestic withholding tax rates instead of treaty withholding tax rates upon payments of dividends, interest and/or royalties to a hybrid entity;
b) The denial of a credit by the residence state for withholding taxes levied by the source state; and
c) The levy of income taxes by two states over the same income.

For example, a company in State A, which distributes a dividend to a hybrid entity in State B (opaque from State B's perspective but transparent from State A's perspective), whilst the shares of the hybrid entity are held by a resident of third State C (State A does not have an income tax treaty with State C). In such a case, State A may levy its domestic withholding tax rate as it sees a dividend payment to third State C, whilst State B may only give a credit for dividend withholding tax under the State A/State B income tax treaty at the reduced rate.[1] Double taxation furthermore emerges if under the domestic laws of a state, certain payments are not deductible for income tax purposes but the corresponding receipts are regarded as taxable income at the level of the recipient in another state or certain payments qualify as different income items under the tax treaty. To illustrate, an interest payment by a hybrid entity that is not recognized (and therefore not deductible) in the state where the hybrid entity is established whilst the receipt of the interest payment by an entity in another state is

[1] Hybrid rules should not be used to address a limitation on benefits question. That is, it may be appropriate to deny treaty benefits to B because B, although a resident of Country B, is not a qualified resident for treaty purposes. ICC believes this has nothing to do with the status of B as a hybrid entity.

recognized as income in the state of residence of such entity and a tax credit will only be given at the reduced tax treaty rate.

From the taxpayer's perspective, the difficulty with double taxation in cases relating to application of tax treaties to hybrid entities is that the double taxation in such situations, in many cases, does not meet the requirements of international juridical double taxation within the meaning included in the Commentary on Article 23A of the UN Model ("These Articles deal with the so-called juridical double taxation where the same income or capital is taxable in the hands of the same person by more than one State"). The UN explicitly mentions that "this case has to be distinguished especially from the so-called economic double taxation", i.e. where two different persons are taxable in respect of the same income or capital. If two states wish to solve problems of economic double taxation, they must do so in bilateral negotiations. In this respect, ICC suggests that the UN Committee takes the position that economic double taxation resulting from hybrid entities should be solved through tax treaties (e.g. by referring to the purposive interpretation of tax treaties being the elimination of double taxation).

The tax arbitrage issues pertaining to hybrid entities basically mirror the double taxation issues. From a tax treaty point of view, it is about the granting of treaty benefits in inappropriate circumstances or at the inappropriate level, amongst others, leading to: (a) the levy of lower withholding taxes; and (b) no levy of income taxes over income earned by a hybrid entity. Tax arbitrage, furthermore, emerges as a result of differences in both the recognition of payments made by or to a hybrid entity under the domestic laws of states and the classification of these payments as income items under the tax treaty. These differences in recognition and classification may lead to:

1) A deduction and/or no levy of withholding taxes in one state and no inclusion in another state (e.g. if a payment to a hybrid entity is deductible in the state of the payer because it regards the hybrid entity as opaque, and the receipt not taxable in the state where the hybrid entity is established as it regards the hybrid entity as transparent);
2) Double deductions (e.g. if a payment by a hybrid entity is deductible in its state of residence, in which it is opaque, but also at the level of the hybrid entities' shareholder, whose state of residence regards the hybrid entity as transparent); and
3) Deferral of the levy of income taxes (e.g. if a payment to a hybrid entity, established in the source state, is regarded to be a payment to such entity's shareholder in the state of the payer, whilst regarded to be a payment to the hybrid entity in the shareholder's state).

2. Possible approaches

Generally, ICC perceives two main ways to deal with the issues pertaining to hybrid entities. Firstly, rules aimed at taking away the root of the issue, which is the different classification of entities under the domestic laws of states. This would mean that either a uniform classification system for entities would need to be developed between states or that states would have to develop coordination rules in their domestic laws. In theory, this type of solution is very appealing as it could potentially do away with all the issues described in Section 1, above. In practice, however, this type of solution does not seem feasible as it, in principle, requires all states to agree on applicable principles and lay down such principles, either in a multilateral instrument or in their domestic laws. That does not seem to be something that is likely to happen in the near future.

Secondly, another way to deal with the hybrid entity issues would be to respect both the different classification of entities by states and the different classification of certain payments in situations involving hybrid entities and to develop rules aimed at taking away the unwanted effects thereof. In this respect, one can, in a tax treaty context think of the principles laid down in the 1999 OECD Partnership Report and, for instance, the hybrid entity provision that can generally be found in US income tax treaties. Very shortly put, the Partnership Report contains five important principles:

1) A hybrid entity cannot be a treaty resident of the state that considers it to be transparent;
2) A partner/shareholder in a hybrid entity that is considered transparent according to the partner/shareholder's residence state, should be entitled to the benefits of the tax treaties entered into by his residence state to the extent of the hybrid entity's income allocated to him;
3) A source state should follow the classification of the state of residence of the taxpayer claiming the benefits of a tax treaty;
4) Relief should be granted by the residence state in cases of conflict of qualification (when residence and source states apply different Articles of the Convention on the basis of differences in their domestic law); and
5) Flow-through of credit.

The hybrid entity provision that can be found in US income tax treaties is generally in accordance with the first three principles. The benefit of an approach based on these principles is that there is a lot of experience with them and that they can be implemented in a bilateral context. Obviously, in order to be effective globally, states should include an Article based on these principles in their income tax treaties which could take a long time to materialize. Furthermore, ICC underlines that such a tax treaty solution would only deal with the inappropriate denial (double taxation) and granting (tax arbitrage) of tax treaty benefits and not with the double taxation, double deduction and deduction/no inclusion issues under states' domestic laws. It is ICC's view that the latter issues can only be effectively dealt with by unilateral domestic legislation alterations, which in effect would place these issues outside of the scope of the UN Committee's work on hybrid entities.

With respect to developing a tax treaty solution (as discussed above), ICC points out that work on Articles 1, 3 and 4 of the UN Model Convention (on e.g. whether a hybrid entity is a person, resident/liable to tax and on entitlement to treaty benefits of the entity itself or of the participants in the entity) is generally relevant for the application of tax treaties to hybrid entities by the source states, while work on Article 23 of the UN Model Convention (with focus on problems related to conflicts of qualification and conflicts of income allocation) is relevant from the perspective of the residence states. According to ICC, it follows that the UN Committee's work on Article 4 and Article 23 should be combined in order to ensure a comprehensive approach to developing any tax treaty solution.

3. ICC's position on taxation of hybrid entities

As put forth in this letter, the issues pertaining to hybrid entities are about double taxation as well as tax arbitrage. ICC feels that in the current international tax environment, the focus is too much on targeting tax arbitrage. ICC acknowledges that arbitrage is an important part of the issue but stresses the importance for business that a balanced comprehensive approach is taken that accounts for the double taxation issues as well. In ICC's view, such balanced approach means that the UN Committee should combine the work on Article 4 and Article 23 of the UN Model Convention (thereby combining source and residence perspectives) and, from a broader policy point of view, should also advocate improvement of dispute resolution mechanisms to avoid double taxation issues, especially if certain structuring mechanisms to (partly) offset double taxation incurred by business, such as certain hybrid entity planning, become impossible. That is, in some cases, taxpayers use hybrid entities and instruments to achieve self-help relief from double taxation. If this becomes impossible, then improving the dispute resolution process to eliminate double taxation through more conventional channels becomes even more important.

With respect to the taxation of hybrid entities, ICC respectfully suggests the UN Committee to focus on both the inappropriate denial and granting of tax treaty benefits in situations involving hybrid entities and the different classification of certain payments in these situations, and, for now, to discard the issues of double taxation, double deduction and deduction/no inclusion under states' domestic laws. ICC believes that the latter issues cannot effectively be solved using treaty provisions and therefore would be outside the scope of the UN Committee's work. As to the income tax treaty issues, ICC notes that it regards solutions in the form of coordination rules or uniform classification systems as theoretically sound but not feasible in view of a lack of a critical mass of states favoring such solutions. ICC consequently urges the UN Committee to deal with these issues by focusing on the development of a UN Model Convention provision based on the principles of the 1999 OECD Partnership Report and the experience of the US in this respect.

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ICC appreciates the opportunity to comment on the hybrid entity issue as it continues to evolve. We hope that our comments will facilitate a constructive way forward.

Respectfully submitted.

Yours Sincerely,

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Chair, ICC Commission on Taxation