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Seminar A:
General Introduction

Chair: Madeleine Simonek
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Panelists

- Madeleine Simonek, Switzerland (Chair)
- Daniel Fehling, Germany
- Elizabeth Gil Garcia, Spain
- John Peterson, OECD
- Kimberly Blanchard, USA
- Mark Brabazon, Australia
- Thomas Dilen, Switzerland (Secretary)

Why this topic?

- Linking of tax systems: understood in a broad sense, not a new phenomenon, but increasing tendency
- «Traditional» forms of dependencies originated from tax treaties:
  - Credit method, exemption method combined with subject-to-tax or switch-over clauses
  - Rules for solving conflicts of qualification
- BEPS 1.0 and 2.0: dependencies stipulated in domestic tax laws:
  - Anti-hybrid mismatch rules
  - Pillar Two mechanism
- Main goals: Avoidance of (double) non-taxation, coordination of tax systems

Seminar’s structure

- Part I: Introduction
- Part II: Purpose and grounds of the linking of tax systems
- Part III: Specific forms of dependencies
  - I) Subject-to-tax clauses; II) Hybrid mismatch rules; III) Pillar Two; IV) United States’ perspective
- Part IV: Discussion of selected practical issues
  - I) Methods of linking; II) Burden of proof and procedural questions; III) Complexity and effectiveness; IV) Discrimination
- Part V: Final statements

Questions or comments are welcomed and answered during the seminar if possible; please use the IFA App

II. Purpose and grounds of linking of tax systems

The beginning of the story…

- In the international arena, the interaction of different tax systems may create uncertainty as well as opportunities for tax avoidance and tax evasion

- League of Nations Report (1927): coordination is required in tax evasion and double taxation: "*…a scheme whereby all income would be taxed once, and only once*"

- Single taxation as an underlying principle?

  - Single tax principle: income from cross-border transactions should be subject to tax once, no more and no less

  - Preventing both double taxation and double non-taxation

The ‘no more than once’ side

- Double taxation was the main preoccupation in the 1920s
- States may introduce unilateral or bilateral mechanisms to prevent double taxation
- Two perspectives:
    - Juridical double taxation: the taxation of the same person in respect of the same income in two or more states
    - Economic double taxation: the same income is taxed in the hands of different persons
- DTCs coordinate the tax rules between contracting states (allocating taxing rights, preventing DT)

The ‘no less than once’ side

- The lack of taxation may have its origin in BEPS practices or it could be an expression of tax sovereignty (e.g. states may exempt certain items of income)
- Shall we prevent double non-taxation? Does it imply a restriction on the exercise of sovereignty?
- The taxation of cross-border income less than once does not necessarily have to be an issue of concern
    - Intended double non-taxation v. unintended double non-taxation

Single taxation as an underlying principle (?)

- There is no obligation of international law to prevent double taxation or double non-taxation
- Implicit principle embedded in tax treaties?
  - The ‘no less than single taxation’ side is not pursued by DTCs unless otherwise provided (subject-to-tax and/or switch-over clauses)
  - STP scope? Juridical double taxation (main purpose of DTCs) and economic double non-taxation (when certain tax treaty provisions are introduced)

II. 1. Dependencies originated from tax treaties

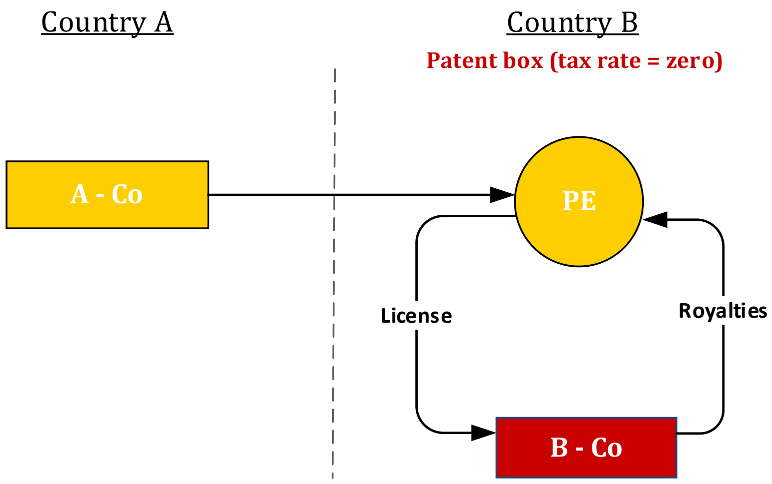
Dependencies originated from tax treaties

- Subject-to-tax clauses
- Switch-over clauses

Subject-to-tax clauses: overview

- Make treaty relief dependent upon taxation in the other state
- May be applied by the source state (e.g. remittance-based clauses) but more often applied by the residence state
- Legal effect: respective treaty relief no longer applicable
- Purpose: prevent double non-taxation

Subject-to-tax clauses: example (patent box)

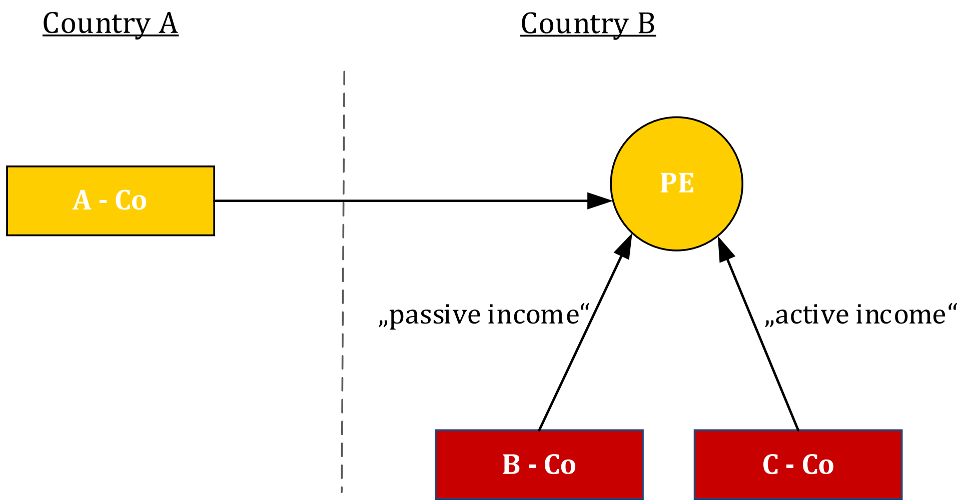


- Art. 7 + Art. 23 OECD MC (exemption method)

Switch-over clauses: overview

- Change from exemption method to credit method
- Applied by the residence state
- Various forms, may be related to
  - „Passive income“
  - Diverging qualification leading to double non-taxation
  - Diverging qualification leading to double taxation (e.g. prevent stranded losses)
  - Notification by one country (*pro futuro*)

Switch-over clauses: example („passive income“)



- Art. 7 + Art. 23 OECD MC (exemption method)
- What happens if both „passive“ and „active income“ are attributable to the PE?

III. 2. Dependencies in domestic tax laws

Overview

- General method of avoiding double taxation: exemption, credit, deduction
- Avoidance of double (non-) taxation in particular anti-avoidance regimes (CFC, transferor trust, …). Similar methods
- Specific rules to (re)characterize entities by reference to foreign tax treatment, e.g. partnerships Policy: some, at least, to avoid double taxation
- Pillar Two rules
- Hybrid mismatch rules – anti-avoidance purpose – the main focus here …

Hybrid mismatch rules

- Action 2 Report (2015); ATAD 1 (2016); ATAD 2 (2017); Branch Mismatch Report (2017)
- Payment + hybrid element + mismatch (D/NI, DD) + causation
- <u>Hybridity</u> identified by tax treatment in each country, including characterization of entities.
- <u>D/NI and DD outcomes</u> identified by tax outcomes in each country / all countries.
  - Deduction against ‘ordinary income’ of a taxpayer of the country.
  - Inclusion in ‘ordinary income’ of a taxpayer of the country.
- <u>Dual inclusion income</u> shelters DD and “hybrid payer” D/NI cases
  - Identified by inclusion in ‘ordinary income’ in >1 country.

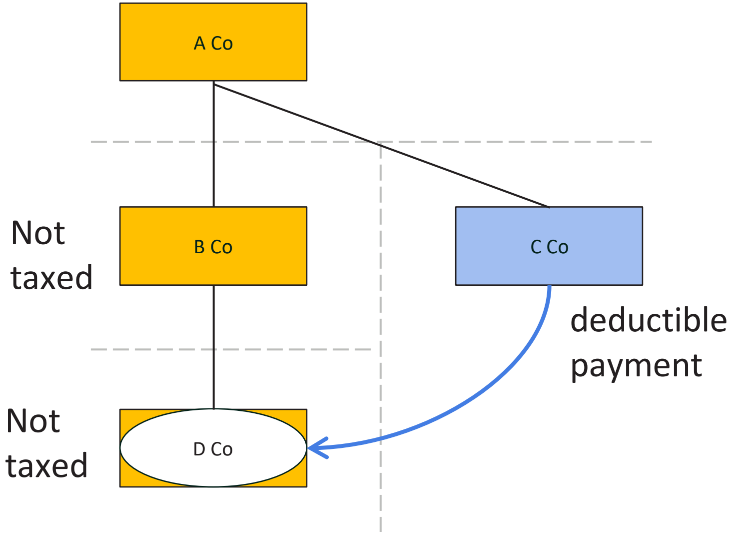
Hybrid mismatch dependencies

- These involve a mixture of doctrinal and concrete elements as well as meta-rules.
  - Characterization is doctrinal, but has concrete consequences.
  - What is ‘ordinary income’ of a ‘taxpayer’ of a country?
    - Subject to conventional net-basis taxation.
    - Generally requires residence or net-basis taxable presence (PE).
  - A country’s ordinary tax rules and rates are respected, but special deals may not be.
  - Special tax deals (collateral rebates, special rates, etc) of whatever kind proportionately reduce ordinary income‘ inclusion’.
  - Parent-country taxation under CFC rules at full rates counts as inclusion in ordinary income.
  - ‘Deduction’ includes equivalent tax relief.

Legal method

- Action 2 and ATAD contemplate local statutes. Variation among these.
- Impact of BEPS Project documents depends on local statute and legal technique.
    - Terms of statute (e.g. NZ) + interpretive rules (what use can be made of extrinsic material?)
- The general approach invited by BEPS Action 2 in assessing the tax treatment in another country is to observe <u>functional equivalence</u> between actual tax treatment and a pattern of treatment described in the recommendations. E.g. ‘inclusion in ordinary income’.
- A doctrinal difference (hybrid mismatch) must be causative of the D/NI or DD outcome.
- The precise doctrine that produces that outcome does not otherwise matter.

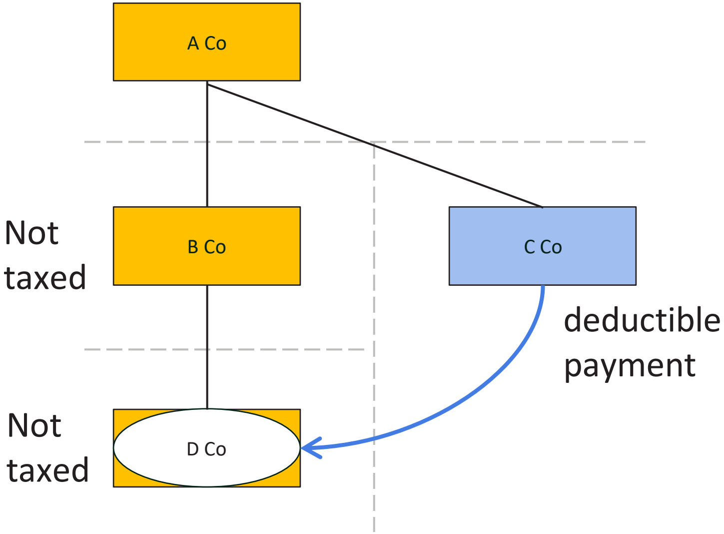
Payment to a reverse hybrid: example 1.1



Deductible payment by C Co in country C to D Co. D Co is established under country D law and fiscally transparent there but fiscally opaque to country B, residence of its owner B Co. All are ultimately owned by A Co in country A. Country C has hybrid mismatch rules.

- Country D does not tax because D Co is transparent.
- Countries A and B do not tax, perceiving D Co as a separate entity.

Payment to a reverse hybrid: example 1.2



Same as example 1.1, except that:

- Country A has a CFC regime which attributes the payment to A Co, resulting in tax at the full corporate rate in A.

Or

- Country A has a regime equivalent to GILTI – or a Pillar Two IIR – under which it taxes A Co.

II.3 – Pillar 2

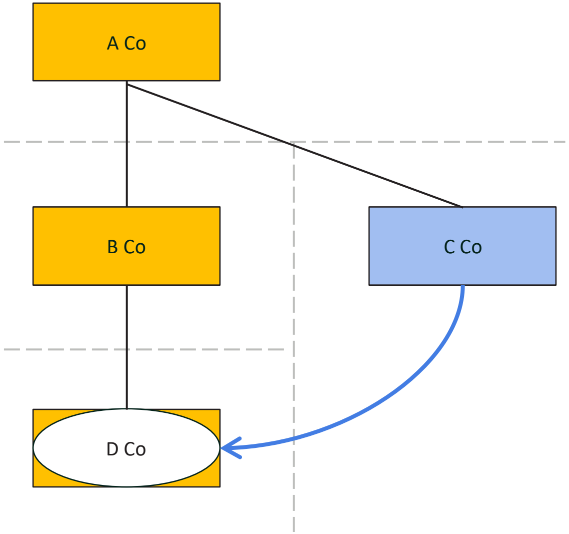
The Origins of Pillar 2

- **GloBE**
  - Extending existing tools to solve specific problems
  - Unresolved issues under BEPS project
    - Profit shifting
    - Substance
    - Transparency
- **STTR**
  - Concern (particularly from developing countries) that treaties could be used as part of structure designed to shift income into low tax structures in residence state

The design of Pillar 2

- **GloBE**
  - A yardstick for determining whether excess profits are being subject to a minimum level of taxation
  - Based on parallel domestic implementation with agreed rule order
  - Need for common and co-ordinated interpretation, implementation and administration (Implementation Framework)

Example – Payment to a reverse hybrid



GLOBE

- D Co a stateless entity under the GloBE Rules
- Inclusion of income under CFC rules could address this issue from a hybrid / GloBE perspective
- Potential interaction / economic double taxation from application of GloBE rules and denial of deduction

III.4 - The US approach to linking

General background

- With only a few exceptions, US tax law does not feature linking to non-US tax law
- US tax fundamental design features differ from those of most other countries
  - US has no territorial exemption: only foreign tax credits limited to foreign sourced income, determined under US tax principles
  - Taxation of worldwide income of US residents and citizens, including by savings clause in tax treaties
  - Comprehensive anti-deferral rules, common law-based tax regime and substance-over-form rules mediated by courts
  - US tax law not dependent on state law commercial characterizations

Reliance on foreign law – factual reliance

- Reliance on foreign **non-tax law** fairly common, e.g.:
  - Evaluation whether foreign financial instrument constitutes debt for US tax purposes
  - US tax classification of foreign legal entity that is not a «per se» corporation
- **Factual reliance**: US tax law relies on foreign facts when relevant, including:
  - Fact of how much foreign tax is paid
  - When does foreign tax legally accrue

Reliance on foreign law – implicit reliance

- Many examples of US tax rules featuring **implicit reliance** on foreign tax law:
  - «Same country» exception from subpart F income
  - Subpart F income: gain on sale of stock v. gain on sale of assets
- Implicit reliance may be based upon an **assumption** of how foreign tax rules operate, whereas explicit reliance is based on how foreign tax rules **actually** operate
  - E.g. Section 267(a)(3) of the IRC defers the deduction of interest paid by a US person to a related foreign person until actually paid, on the assumption that the related person would not be subject to tax on an accruals basis

Explicit non-reliance is general rule - examples

- Foreign tax credit rules generally limit the credit to foreign tax on foreign source income as determined using US tax principles only
  - No attempt to reconcile US and foreign substantive tax results → often double taxation
  - E.g. source rules for capital gains can treat such gains as US source income even if subject to foreign taxation → double taxation
- But in the case of a «covered asset acquisition,» US tax basis step-up ignored to prevent “hyping” of foreign tax credit (unless foreign tax law gives a similar step-up)

Reliance on foreign law – explicit reliance

- Legal or **explicit reliance** on foreign law **extremely rare** and few exceptions quite recent in origin
    - No subject-to-tax or switch-over clauses, not even in tax treaties
    - US generally does not attach importance to whether foreign country taxes or not
        - If no foreign tax, no foreign tax credit and more US tax
    - US does not conclude tax treaties with tax havens and rejects tax sparing categorically

Explicit reliance – examples

- US **anti-hybrid rules** feature different forms of linking:

  - Regulations under Section 894 of IRC apply only for treaty purposes and merely ask whether country «sees» income due to tax transparency; actual taxation irrelevant

  - Section 267A of IRC, based on BEPS, operates without regard to treaty policy and asks whether payment of interest/royalty is actually subject to tax

  - Section 909 defers US foreign tax credit until income is taken into account in foreign country; usually applicable in hybrid cases

GILTI vs. Pillar Two, New Foreign Tax Credit Regulations

Nature of GILTI (1)

- GILTI applies without regard to foreign tax law; **not a minimum tax on foreign income**
- US has always taxed worldwide income:
  - including active income of foreign branches without deferral
  - including dividends from active subsidiaries; but historically tax on dividends deferred until dividend declared; subpart F enacted in 1962 to prevent such deferral for certain passive and certain mobile income; applies to all CFCs
- **GILTI extended the repeal of deferral to active CFC income** (minus allowance for tangible asset basis, similar to Pillar Two carve-out). Uses same rules as subpart F; applies to all CFCs
- GILTI imposed at **half the tax rate** applicable to other income for competitive reasons > acceleration of what almost no other country would tax *at any point in time*

Nature of GILTI (2)

- Confusion on whether GILTI = **CFC regime** or **QIIR under Pillar Two**:
  - Not a typical CFC regime: not an anti-abuse rule; merely accelerates taxation of active offshore income
  - Not a typical minimum tax: not limited to low-tax CFCs or designed to tax excess profits (except for a return on adjusted basis of tangible assets)
  - Recent enactment of a 15% alternative minimum tax on large US corporations, based on book income including income of all consolidated subsidiaries worldwide, unrelated to GILTI or Pillar Two, but may be acceptable for Pillar Two purposes
- Primarily a **political** question

New Foreign Tax Credit Regulations

- Reversing decades of precedent: strictly «objective» set of rules essentially asking whether foreign tax «corresponds» to US income tax

- Does any foreign tax qualify as a foreign income tax under the new rules?

- Extensively criticized issues:

  - Requirement that foreign country's sourcing rules match those of the US; e.g. US sources royalties based on place of use of the IP, whereas many other countries place source by residence of the payor

  - Requirement that foreign country allow cost recovery (depreciation or amortization) in a manner similar to US rules recently loosened

Part IV.1: Methods of Linking

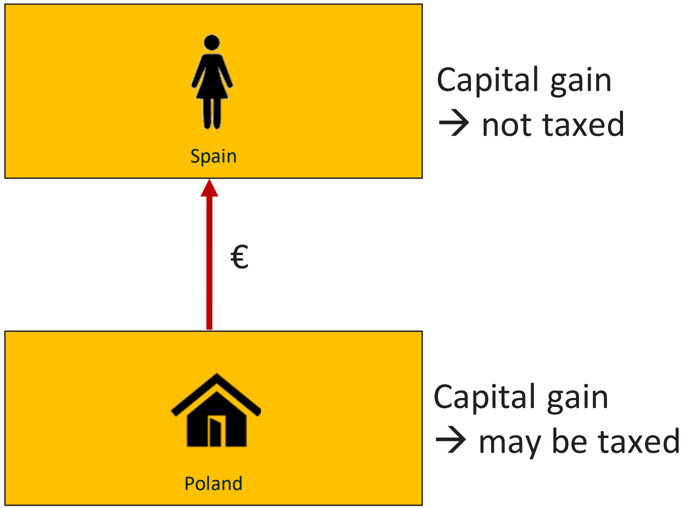
Two main methods of linking of tax laws

- Linking to the legal order of the other state
  - Sufficient to explain and prove the legal system of the other state

- Linking to the effective taxation in the other state
  - What does effective taxation means: liability to tax or effective payment of tax?
  - What is the impact of specific situations such as loss situations, special (preferential) tax regimes, tax exemptions, tax allowances, statute of limitations, etc.
  - Who bears the burden of proof and what are the requirements for proof?
  - What are the consequences of timing differences?
  - Are rulings of foreign courts and administrations binding for another state?

Example: Subject-to-tax clauses

Meaning of being taxed in the other State: example 1

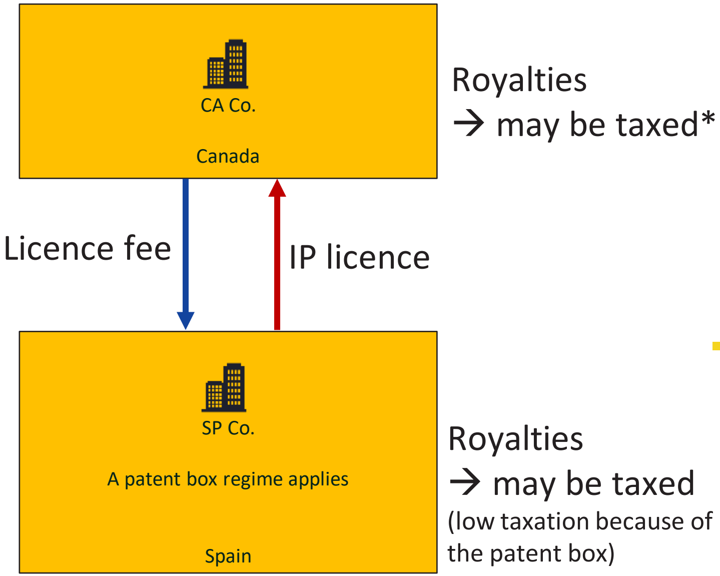


- Art. 13 DTC Spain-Poland: *“gains derived by a resident of a Contracting State from the alienation of immovable property situated in the other Contracting State* ***may be taxed*** *in that other State”*

- Ruling issued by the Spanish General Directorate of Taxes on 26 July 2018 (no. V2232-18):

“*According to art. 23 of the DTC Spain-Poland, when a resident in Spain obtains an income that may be taxed in Poland, Spain should exempt such item of income from taxation. Therefore, as art. 13 of the treaty allows Poland taxing the capital gain, such gain should be exempt from taxation in Spain,* ***regardless of whether the gain is effectively taxed in Poland in accordance with the Polish domestic legislation***”

Meaning of being taxed in the other State: example 2



- Art. 12 DTC Spain-Canada: royalties may be taxed in the residence state (primary taxing right). However,

  *"such royalties may be taxed in the Contracting State in which they arise, and according to the law of that State; but the tax so charged shall, provided that the royalties **are taxable** in the other Contracting State, not exceed 10 per cent of the gross amount of royalties"*

- The SP Co. is taxed under a preferential tax regime (patent box)
  - Meaning of 'are taxable'
  - Spanish version of the treaty: *"sujetos a imposición"* (= subject to tax)

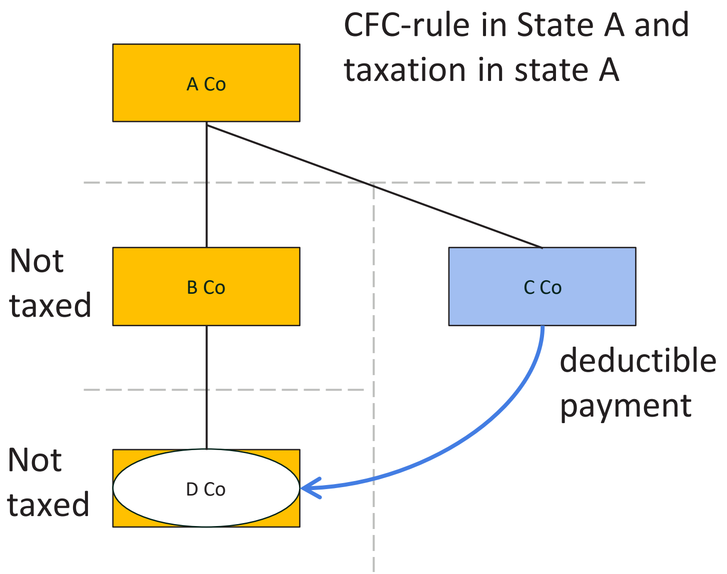
Meaning of being taxed in the other State

- Liability to tax v. effective taxation

- Example 2: a subject-to-tax rule has been introduced
  - Royalties are subject to tax in Spain, even though there is no effective taxation because of the patent box.
  - Therefore, Canada is only allowed to tax the royalties up to 10%

IV.2. Burden of proof and procedural issues

Burden of proof



Facts that need to be established

- Non-taxation in the state of the recipient of the payment?
- If yes: what is the reason for non-taxation?
- If hybridity: is the payment taxable in another state, at hand in state A because of CFC rule?

Requirements and burden of proof

- What are the requirements of proof?
- Is the burden of proof on C Co or on the tax administration?
- What happens if C Co does not receive the necessary information from A Co?

Inquisitorial principle

- Inquisitorial principle combined with an obligation to cooperate:
  - Tax administration must assert the facts, taxpayer is obliged to cooperate.
  - In cross-border situation generally higher duty to cooperate
- Burden of proof:
  - Tax administration bears the burden of proof for facts that increase the tax burden, taxpayer for facts that reduce the tax burden
- At the case at hand:
  - Tax administration must prove non-taxation in State B and D and causal connection, C Co must prove taxation in State A
  - C Co is obliged to cooperate and deliver the necessary information as far as actually and legally possible
  - If C Co is not able not receive the necessary information, tax administration should initiate an exchange of information procedure

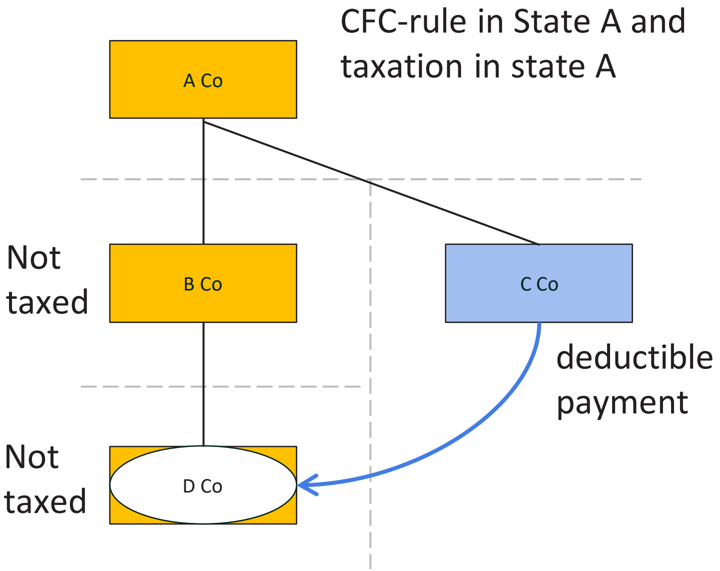
Burden of proof (AUS)

- Foreign law is treated as a matter of fact.
- The onus of factual proof is on the taxpayer in most tax litigation.
- The standard of proof is on the balance of probabilities, i.e. the ordinary civil standard.
- Foreign law is usually proven by expert testimony. Proof of foreign tax treatment does not require any particular form of evidence.
- Difficulties of proof are dealt with as a matter of weight. 'All evidence is to be weighed according to the proof which it was in the power of one side to have produced, and in the power of the other to have contradicted.'
- If the taxpayer has to disprove a proposition, the depth and nature of evidence required will reflect the nature of the proposition and whether any reason appears to suspect that it is true.
- The Commissioner's exchange of information powers (CMAA etc) may be used to ascertain foreign tax treatment, including of a relevant person other than the taxpayer.

Burden of proof (USA)

- Tax is not assessed in first instance by IRS: each taxpayer required to file own tax return
- US court rules treat dispute over foreign law as question of law
  - Generally proved by expert testimony, translated excerpts
- US law imposes burden of proof on party seeking to apply foreign law
- Nothing addresses question of who has burden of proof where linking is made explicit in the Code: never done before

Timing issues



1. Different assessment periods:
   - C Co deduction in 2022, A Co CFC rule taxation in 2023

     → should principally not be a problem
2. Final assessment:
   - C Co is finally assessed for 2022 in 2025, deduction is not granted, because of non-taxation in states B and D
   - In 2029 only, it turns out that the payment was taxed in state A
   - Does C Co has the right to ask for a reopening of its tax assessment?

Timing issues: different perspectives

- Most civil law states: Request for reopening should be possible, time limits differ considerably from state to state
- Australia: De-facto reopening is by objection. Ordinarily, the objection must be made within two or four years from original assessment, depending on classification of the taxpayer.
- US: Tax liability becomes fixed upon: i) statute of limitations; ii) undisputed, final IRS assessment; iii) entry into final IRS settlement; iv) final, non-appealable court decision
  - No basis to reopen final tax determination: appellate court may “reopen” lower court’s tax case in extraordinary circumstances revealing clear abuse of discretion
  - Could include clearly erroneous finding as to foreign law

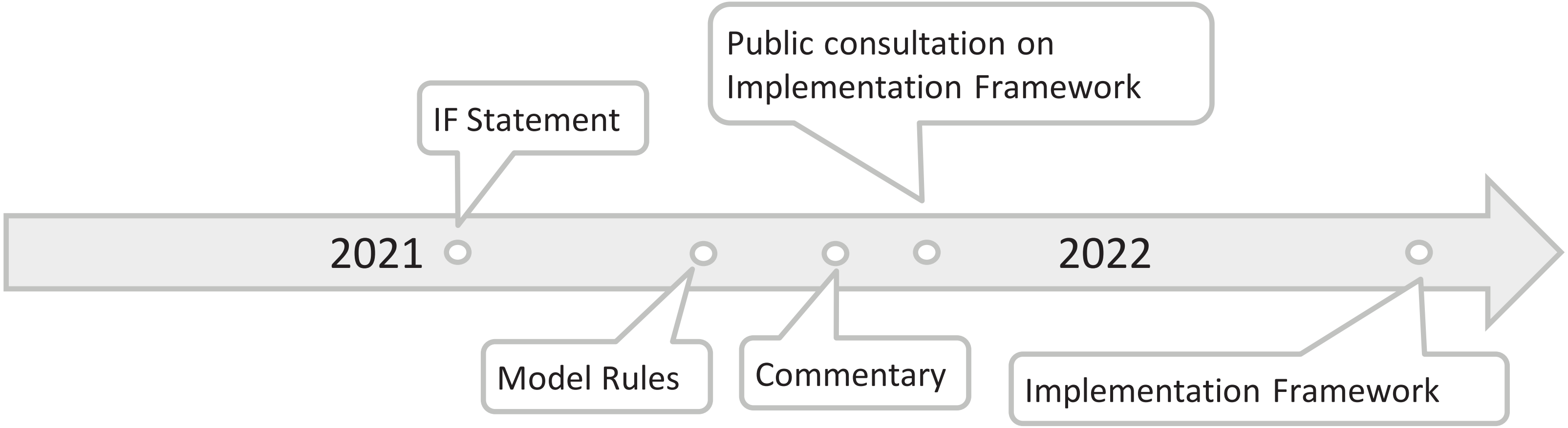
IV.3 – Complexity and Effectiveness

Common Approach

Inclusive Framework Statement (October 2021)

The GloBE rules will have the status of a common approach. This means that IF members:

- *are not required to adopt the GloBE rules, but, if they choose to do so, they will implement and administer the rules in a way that is consistent with the outcomes provided for under Pillar Two, including in light of model rules and guidance agreed to by the IF;*
- *accept the application of the GloBE rules applied by other IF members including agreement as to rule order and the application of any agreed safe harbours.*



Implementation framework

Peer review process

Further administrative guidance (interaction with US rules)

Safe-harbours

Common filing and exchange requirements

Dispute resolution / tax certainty mechanism

IV. 4. Discrimination

Discrimination

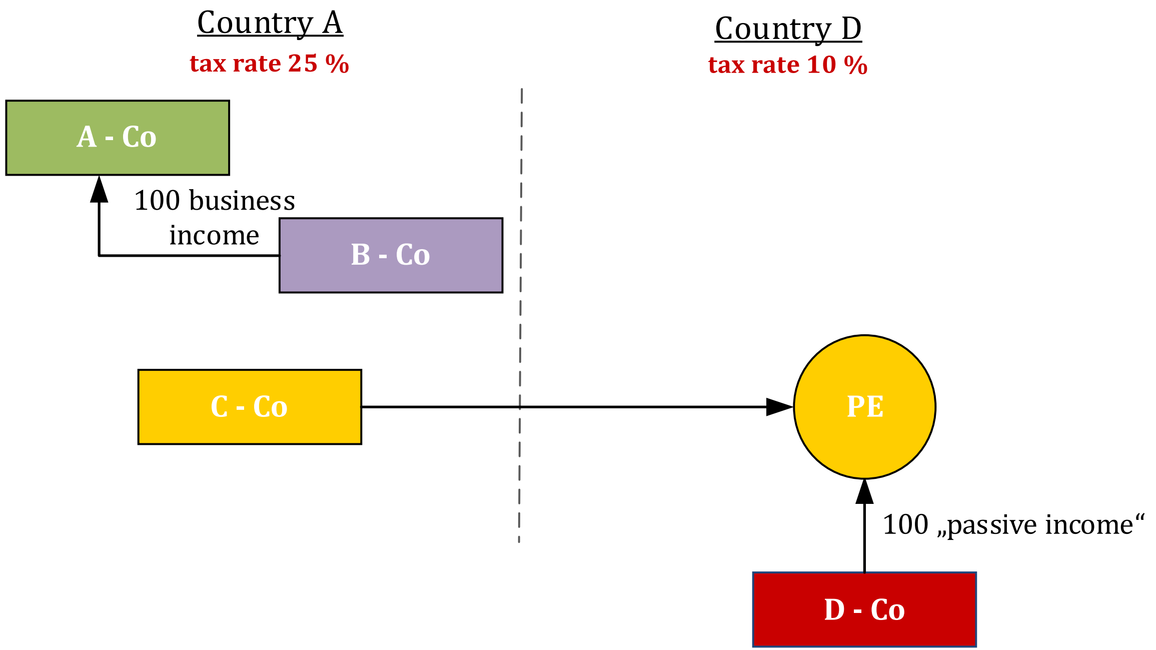
- Different treatment of constellations that are to be regarded as equivalent
- In particular: less favourable treatment of cross-border constellations *vis-a-vis* domestic constellations (maybe also referring to „nationality“)
- Might give rise to discrimination issues
- Non-discrimination principle may have different legal bases:
  - Domestic constitutional law
  - Art 24 OECD MC
  - EU law (fundamental freedoms, human rights)
- Review steps
  - Equivalence of situations?
  - Less favourable treatment?
  - Justification possible?

Equivalence of constellations/less favourable treatment

- Equivalence of constellations and existence of less favourable treatment need to be assessed carefully with respect to different linking rules

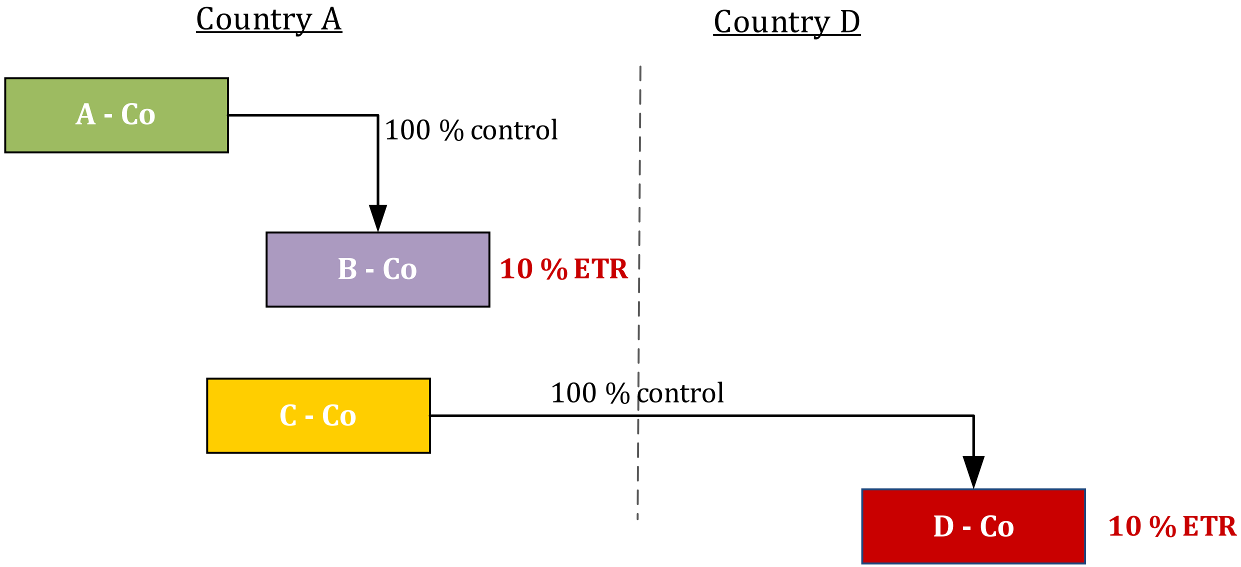
- Two examples:
    - 1) Switch-over rule
    - 2) IIR (GloBE Model Rules)

Example 1: switch-over rule



- Switch-over rule: switches from exemption to credit method and thereby leads to „homestate taxation“: *equal treatment?*

Example 2: IIR (GloBE Model Rules)



- IIR leads to an additional top-up tax charge, applicable only in cross-border situations: *not equal treatment?*

Justification possible?

- Again: depends on the concrete linking rule at stake (and on the legal basis for the anti-discrimination rule)
- Possible justifications:
  - protection of a country‘s tax base as viable justification?
  - anti-avoidance/anti-BEPS as a viable justification (maybe even leading to a *per se* carve-out from DTC protection)?
  - group perspective: look at the „aggregate“ or „corresponding“ tax treatment in the group?
  - refer to underlying international agreement (e.g. ECJ in *Gilly*)?
  - in the EU: „immunity“ against fundamental freedoms/human rights if enshrined in EU directive?

V. Conclusions