Budapest, 25 June

THE INTERNAL MARKET: FACTUAL EXAMPLES OF DOUBLE NON-TAXATION CASES [TAXUD D1 D2012)]

Non-governmental organisation:
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Declaration:
We agree to the publication of the personal data and the responses given to the TAXUD consultation paper.

In general, we would like to point out that we support the consultation process and the aim of the EU Commission to tackle double non-taxation issues. At the same time, and in line with the principle of subsidiarity within the EU, we believe that the scope of consultation should be restricted to those instances of double non-taxation, which are not caused by the unilateral measures of one jurisdiction (such as to levy nil or heavily reduced taxes, etc.). A reason for this is that most of these cases could, from the point of view of the other country, be tackled by appropriate unilateral measures of such other country. These measures could involve general or specific anti-avoidance rules (such as CFC legislation), the application of withholding taxes, or a combination of these or similar measures. In the aforementioned cases (which we have specifically indicated at the appropriate questions), national legislation appears to be more appropriate to address these issues.

From the point of view of taxpayers, double non-taxation is not really a problem. Most taxpayers would actually strive to exploit theses possibilities. Therefore, tax advisors, we would generally be reluctant to comment on these issues. However, we believe that where double non-taxation occurs, double taxation could also usually occur in the reverse situation. Therefore, we would welcome and promote an approach whereby double non-taxation issues are solved together with (and not instead of) double taxation problems. This is a major driver for us to participate in this process.

Yet we are also aware of the significance of legal certainty. Taxpayers may well seek not only to minimise their liability to pay tax, but also to avoid tax risks. In this respect, clarification of double non-taxation issues may be of high importance for all stakeholders of taxation. Therefore, the consultation paper released by the Commission is warmly welcome.

Responses

Issue 1 – Mismatches of entities

Question A: Yes

Question B: Yes

Question C:

We have certain doubts as to whether the example quoted is really relevant. In any case, we

feel that in order for double non-taxation to occur in the given example, a number of specific circumstances must be present: Country A must not regard the "hybrid" to be a PE of the Parent (as otherwise, it would probably not allow the deduction of interest, save for special circumstances such as cross-border tax grouping), and Country B must have in place a group relief regime, which, for instance, Hungary does not have.

Notably, as a Hungarian registered partnership is fiscally opaque, interest deduction with a Hungarian partnership as a debtor is available irrespective of the fact that the same entity is treated as a transparent entity from the perspective of the parent company's jurisdiction. As such, interest deduction could be possible with the parent as well. Hungarian tax deduction cannot be denied for this reason.

A mismatch of entities can be relevant in a number of other cases, the most prominent of which is where Country A (in which the parent is located) considers its hybrid subsidiary in Country B to be a transparent PE whereas Country B regards the same entity as a company. When the hybrid is sold, Country B would generally regard that it is not entitled to tax the capital gains on such a sale whereas Country A does not regard it either as being entitled to tax those gains (treating the gains as the income attributable to the PE). The result will be double non-taxation, and this is indeed a mismatch that has frequently been exploited in the past. Notably, no effective Hungarian double tax treaty has had yet a draft of Paragraph 4 of an Article equivalent to Article 23A OECD model.

Question D:

We believe that an EU-wide list of non-transparent entities for double taxation purposes could go a long way of solving this problem. The lists in the Merger and Parent-Subsidiary Directives could be used as a very good starting point.

Issue 2 – Mismatches of financial instruments

Question A: Yes

Question B: Yes

Question C:

This is one of the most typical and most exploited forms of double non-taxation, and it is impossible to list the many kinds and circumstances. However, most of them do seem to follow the basic pattern as described in the Commission's example.

Mismatching is thus not precluded even in Hungary. Participating loan is always considered in Hungary as a loan. The Hungarian debtor can thus get access to interest deduction in the instance that the income the creditor receives may be qualified in the non-Hungarian situation as the dividends received, exempt from taxation there. Hungarian interest deduction cannot be denied for this reason. Such a scheme is proliferated, for example, in respect of the (quite obsolete) Netherlands – Hungary double tax convention.

Question D:

The mismatching addressed by Issue 2 goes to the heart of the tax and accounting legislation

of each country, which is very difficult to overcome by definitions in any treaties. We believe that this issue may primarily be solved by promoting some kind of harmonisation of these rules, such as the CCCTB initiative. Switch-over clauses (as domestic, unilateral measures) could also be a good way of coping with his problem, but those clauses are much more restrictive on taxpayers and therefore on the fundamental freedoms of Community law.

Issue 3 – Application of double tax conventions leading to double non-taxation

Question A: Yes

Question B: Yes

Question C:

This is also a typical source of double non-taxation as well as double taxation. From the point of view of the taxpayers, it is mostly problematic where either there is a mismatch of facts or that of timing. The first issue should be easy to avoid by adequate communication between the tax authorities, whereas the second one should be overcome by a less formal application of the concept of "tax period" or "tax year", combined with better communication.

Foreign earned business income can be exempted from taxation in a Hungarian treaty situation irrespective of the fact whether the Hungarian beneficiary does or does not pay in fact tax abroad. The Hungarian tax authorities do not usually request the taxpayer to prove that tax has been paid in the other jurisdiction on the income to be exempted from Hungarian taxation. In a few recent cases (see, e.g., the new Hungarian treaty concluded with the US in 2010, and with the UK and Germany in 2011), exemption is subject on the Hungarian side to effective taxation applied in the other contracting state. As discussed, no effective Hungarian double tax treaty has had yet a draft of Paragraph 4 of an Article equivalent to Article 23A OECD model.

Question D:

Better communication between the tax authorities, perhaps aided by a permanent forum for solving intra-EU double (non) taxation issues could go a long way of solving many issues in a quick and straightforward manner. Ultimately, though, the solution could only be either the harmonisation of tax rules (e.g., CCCTB) or the application of an EU-wide, multilateral international treaty or a Council Directive on the avoidance of double (non) taxation.

Issue 4 – Transfer pricing and unilateral advance pricing arrangements

Question A: No

Question B: Yes

Question C:

A unilateral APA is regulated in detail in Hungarian statutory law. The local business community has welcomed its introduction. The Arbitration Procedure Convention does not seem to be efficient. Formation of arbitration panels has not yet been known in Hungary,

although Hungarian experts have been listed with the Joint Transfer Pricing Forum to work as arbiters.

Question D:

We feel that this is one of those issues where existing and/or purely unilateral measures should be enough to tackle the problem, and should be left out of the scope of the present consultation. Better use of MAPs, better use of the exchange of information clauses should be enough to eliminate most of these issues, or simply a better unilateral regulation of the APA processes. Ultimately, though, the elimination of transfer pricing problems could only come through the elimination of transaction-based transfer pricing approaches instead of more robust and fail-safe systems (e.g., formulary apportionment) or CCCTB.

Issue 5 – Transaction with associated enterprises in countries with no or extremely low taxation

Question A: No

Question B: Yes

Question C:

The dividends received inside or outside Hungary are exempt from corporate tax. It is not precluded that the taxpayer benefits from this regime irrespective of the fact whether the subsidiary, out of which dividends are paid, is subject to normal taxation.

As an example for mismatching that can occur in Hungary, it can be mentioned that interest of the loan can be deducted, which is paid to a creditor subject to low tax or no tax, although the burden of proof is laid on the debtor to prove genuine business purposes, and interest must be consistent with pricing at an arm's length. Interest deduction cannot yet be denied for the sole reason that the creditor is not subject to taxation comparable to the Hungarian debtor's tax liability, or is not subject to taxation at all due to the qualification of the other jurisdiction, different from the Hungarian one.

Question D: These issues should be solved on a unilateral basis (anti-abuse, CFC, etc. legislation) and should be left out of the scope of the present consultation. Please see our general remarks above.

Issue 6 – Debt financing of tax exempt income

Question A: No

Question B: No

Question C:

Interest deduction is not precluded in Hungary, even if the income received is not taxed, e.g., due to dividends received deduction, although double dip is prohibited by statutory law in general. One can argue in this case that the benefits of interest deduction and exempted dividends do not derive from the same factual circumstances. Interest deduction is not

precluded either where the creditor is a PE of the Hungarian company that operates in a low-tax jurisdiction. For example, privileged Swiss PEs are used by Hungarian companies to generate through it income from private loans. This does not seem to be restricted either by the Hungarian, or the Swiss tax authorities.

The interest expense assumed by the holding company of an LBO scheme can be used to reduce the taxable basis of the target company after merger. This is not prohibited under Hungarian statutory law, although such a scheme can be challenged by the tax authorities, based on a GAAR.

It is noteworthy that foreign resident corporate taxpayers do not pay tax in Hungary, but in exceptional cases. Therefore, the income of dividends, interest, royalties and capital gains derived from the disposal of shares is widely exempt from Hungarian corporate taxation despite the fact that the beneficiary may operate in a low-tax jurisdiction.

Question D: These issues should be solved on a unilateral basis (anti-abuse, CFC, etc. legislation) and should be left out of the scope of the present consultation. Please see our general remarks above.

Issue 7 – Different treatment of passive and active income

Question A: No

Question B: No

Question C:

As discussed, interest and royalty deduction is independent in Hungary of the fact whether the beneficiary of payment operates in a low-tax jurisdiction. This may cause double non-taxation with the beneficiary because the income the latter derives is exempt from Hungarian taxation (at the moment there is no withholding tax in Hungary that would be applicable to the Hungarian-earned income of foreign enterprises).

Question D: These issues should be solved on a unilateral basis (anti-abuse, CFC, etc. legislation) and should be left out of the scope of the present consultation. Please see our general remarks above.

Issue 8 – Double tax conventions with third countries

Question A: Yes.

Question B: No

Question C:

Hungarian double tax conventions typically do not contain tax sparing clauses. Double non-taxation can still occur in a few cases. For instance, under the Hong Kong – Hungary treaty, Hungary does not require effective taxation while granting exemption on the Hungarian side. At the same time, Hong Kong may exempt from Hong Kong taxation under its national law the passive income derived through a Hong Kong-based PE of a Hungarian enterprise outside

Hong Kong.

Question D:

Although we feel that these issues could be relevant for the future discussion on double non taxation, the EU should at present primarily concentrate on solving double (non) taxation that occurs within the EU. Given the "four freedoms" regime in an EU context, full elimination of double (non) taxation within the EU should be a priority. Indeed, we cannot really talk of a true internal market as long as these issues are not solved by either harmonisation measures as the CCCTB, or by adopting a multilateral instrument on the avoidance of double (non) taxation within the EU.

Issue 9 – Disclosure

Question A: No

Question B: No

Hungary has not yet taken any step to introduce voluntary disclosure rules or apply any method that would be applied with a view to constituting any form of an enhanced relationship to be established under the respective OECD documents. Hungary applies advance rulings, but has not launched so far any project on the horizontal enforcement of taxation rights and liabilities. In general, no special disclosure rules, whether mandatory or voluntary, are aimed at aggressive tax planning.

Issue 10 – Other issues

The Hungarian CFC legislation does not seem to be efficient. Notably, there are no income or asset tests to filter out passive income or tainted assets. The definition on genuine business activity is dubious. As passive income is not excluded from the scope of substantive business activity, it can happen that a CFC operates in a jurisdiction with a ring fencing regime, obtains income from third countries to meet the offshore criterion of the low tax jurisdiction, and yet able to show genuine business activity there from the purposes of Hungarian legislation. Interestingly, the Hungarian CFC law does not refer to the lack of the comprehensive exchange of tax information across the border. Besides, there are no comprehensive reporting obligations in Hungary on the offshore activity of business.