UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL

Mr. Pascal Saint-Amans
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Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)

Dear Mr. Saint-Amans,

The United States Council for International Business[1] is pleased to provide comments on the OECD's Discussion Draft on Neutralising the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws). We appreciate that the OECD is seeking early input on these important topics. USCIB supports the BIAC consensus comments. We will not repeat those comments here, but rather would like to emphasize some key points.

Interaction with Other BEPS Action Plan Items

The BEPS Action Plan items interact with each other. For example, changes to the rules concerning deductibility of interest expense, the application of CFC rules, treaty anti-abuse rules, and increased disclosure will all likely increase corporate tax payments and reduce the use of hybrid instruments and entities which will reduce the need for hybrid mismatch rules. Further, the proposed rules on hybrids and other BEPS action plan actions will increase both double taxation and the likelihood of double taxation. We believe that it is important to do an impact assessment of the effect of all of the proposed changes on cross-border trade and investment. Countries may collect some additional tax from companies, but some significant portion of those revenue gains may be offset by reduced foreign direct investment and the concomitant loss of jobs and spill over effects on their economies. These sorts of changes are not easily undone. So while we understand the OECD/G20's concern with double non-taxation, it is important to proceed with care.

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

Complexity and Double Taxation

The rules proposed in the Discussion Draft are overwhelming complex and will be extremely difficult to administer. The rules assume a remarkable level of knowledge both on the part of taxpayers and tax administrations concerning the operation of foreign law and the way payments flow-through a structure. The proposed definition of a related person, which uses a 10% threshold, is too low for two reasons. First, depending on how stock attribution rules work, it will be difficult to know if different related entities that have minor ownership interests in the same entity together reach the 10% threshold. Second, if one entity owns only 10% of another entity, the information necessary to implement the hybrid mismatch rules simply will not be available. USCIB, therefore, believes that this threshold should be raised to at least 50%.

Fundamentally, however, the OECD has assumed that a problem that arises because sovereign countries do not agree on the tax treatment of certain instruments or entities can be resolved by sovereign countries agreeing on the tax treatment of hybrid mismatch arrangements. This strikes us as unlikely. A more likely outcome in our view is that the proposed rules will be adopted piecemeal by some countries, there will be significant differences in the way terms are defined, and uncertainty and double taxation will increase. One possible way of avoiding this piecemeal approach is to defer adoption until a critical mass of countries have adopted these rules. The Discussion Draft recognizes that one positive outcome from "dealing with hybrid mismatches on a multilateral and coordinated basis is that compliance costs would reduce significantly after a critical mass of countries adopts the same rule." (Para. 44) Since the Discussion Draft recognizes that workability and compliance costs are important design principles and adoption by a critical mass of countries will further these goals, the rules should not apply until a critical mass of countries have adopted the rules.

Exemptions vs. Foreign Tax Credits

Most countries in the world have adopted territorial systems that follow the principle of capital import neutrality and exempt dividend income from residence country tax. The fundamental principle of capital import neutrality is that foreign companies operating within a jurisdiction pay tax at the same rate as domestic companies operating within that country and therefore foreign and domestic companies compete on a level playing field within that country. This is a fundamental choice made by countries to encourage the competitiveness of their industries in foreign markets. The consequence of this choice is to forego the potential additional revenue that would be paid on foreign source income of companies that are resident in that jurisdiction. The Discussion Draft, however, provides that "the payee jurisdiction should not be required to extend relief from economic double taxation under domestic law in circumstances where the payment has not borne underlying tax[2]." (Para. 84) This seems misguided to us because this is precisely why a country would choose to adopt an import neutral system: to give the benefit of the foreign rate reduction (including a reduction to zero) to the taxpayer to improve competitiveness in the local jurisdiction.

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[2] This paragraph refers to the payment bearing tax, not being subject to tax. Countries that want to relieve double taxation only when the income has borne foreign tax adopt foreign tax credit systems, not exemption systems.

Some countries (including the US) have continued with a worldwide system with a foreign tax credit; this capital export neutral system is intended to create a level playing field between the choice of a domestic (US) investment and a foreign investment for a domestic (US) company.

The choice between capital import neutral systems and capital export neutral systems while leveling one playing field unavoidably "tilts" the playing field in another direction. That is, the capital import neutrality will encourage foreign investment, if the tax rate in the foreign jurisdiction is lower. Capital export neutrality will disadvantage a company from the export neutral jurisdiction against foreign competitors, if the tax in the capital export neutral jurisdiction is higher than in foreign jurisdictions. As discussed in more fully in our letter on the digital economy, companies do respond to these incentives in deciding where to locate productive investment, including decisions on where to locate company headquarters[3].

Why is this relevant to hybrid mismatch arrangements? Countries with import neutral systems have made a very fundamental policy choice; they have chosen to promote the competitiveness of their companies operating in foreign markets (and therefore have encouraged companies to make their headquarters resident in that country) over collecting residual tax on low-taxed foreign source income. This choice, and not the use of hybrids, is the root cause of much of the tax planning that countries find objectionable. Further, much of the hybrid planning US companies have engaged in is designed to achieve the effect of a territorial system even though the US has not adopted a territorial system. For a country that has adopted a capital import neutral system, the use of planning by taxpayers to achieve a similar effect should not be objectionable to that country.

Withholding Taxes

USCIB believes the hybrid mismatch rules should not apply if the payment is subject to withholding tax. There are two reasons for this conclusion. First, income that is subject to withholding tax is not stateless or non-taxed income. A lower rate of tax on gross income frequently results in a higher effective rate of tax than a net basis tax imposed at a higher rate. Second, it does not meet the D/NI standard set forth in the Discussion Draft. If the income is subject to withholding tax, it should not be subject to the hybrid rules at all because the predicate of deduction/no inclusion does not exist. The recipient of the income has gross income (interest, dividends and royalties are ordinary income, not capital gains) in the source country and therefore the rule, by its terms does not apply. Withholding is simply a mechanism for collecting tax; it does not change the nature of the income or the fact of liability. Taking the contrary view, imposing a withholding tax and denying a deduction, would clearly result in double taxation.

[3] See, New York Times Article, *Pfizer Proposes a Marriage and a Move to Britain, Easing Taxes,* April 29, 2014. The United Kingdom has sought out both headquarters companies and IP companies by lowering their corporate tax rate, easing their CFC rules, and adopting a patent box regime.

Scope Issues

While we believe finalizing this paper is premature given that the interaction with other items may significantly curtail the need for hybrid rules, we provide the following comments on scope.

The OECD should use the "bottom-up" approach which is significantly narrower than the "top-down approach". We reiterate our comment on the need to define related parties more narrowly, using a 50% threshold.

The proposed rules on imported mismatches should be removed. The BIAC comment letter sets forth in detail the problems that would be created by adoption of the imported mismatch rule. USCIB would like to emphasize two points: complexity and the extra-territorial reach. These very complex rules reach the peak of complexity in the context of imported mismatches. If a non-hybrid payment out of a jurisdiction is arm's length, does not violate thin capitalization rules, and has only received treaty benefits under an appropriate LOB provision, then that should be the end of the matter as far as that jurisdiction is concerned. To provide otherwise is to let a third country undo the policy choices of other sovereign countries. This is inappropriate.

The OECD is also interested in standards that can be used to identify structured transactions that ought to be subject to the rules. USCIB would like to identify two sets of rules that might serve as a model for identifying structured transactions. The US has adopted rules for identifying such transactions under section 6011, concerning tax shelter disclosure, and 901, concerning foreign tax credit generators. Either of these could serve as a model for the OECD.

Sincerely,

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