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Executive Director

W. PATRICK EVANS
Chief Tax Counsel

1 May 2014

Mr. Achim Pross
Head, International Co-operation
and Tax Administration Division

Ms. Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing
and Financial Transactions Division

Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
Paris, France

Via Email: aggressivetaxplanning@oecd.org, taxtreaties@oecd.org

RE: Discussion Drafts on BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Law and Treaty Issues)

Dear Ms. de Ruiter and Mr. Pross:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Action Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries' tax bases are being eroded or profits shifted improperly.

Pursuant to the Action Plan, the OECD issued two public discussion drafts on 19 March 2014, each of which addressed issues arising under BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements. One draft sets forth recommendations for changes to domestic law (hereinafter the Domestic Draft), and the other draft discusses certain treaty issues (hereinafter the Treaty Draft, together with the Domestic Draft, the Discussion Drafts). The Discussion Drafts discuss the policy issues that may arise from tax planning that utilises the

differences in the tax treatment of instruments and entities across jurisdictions and sets forth recommendations to address those issues.

On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for comments on the Discussion Drafts.[1]

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 55 chapters in Europe, North America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 members represent over 3,000 of the largest companies in Europe, the United States, Canada, and Asia.

TEI Comments on the Domestic Draft

TEI commends the OECD for its discussion of the issues that arise from differences among various countries' tax laws. The Discussion Drafts, in general, accurately describe the compliance and financing challenges that multinational enterprises (MNEs) confront when faced with non-uniform tax regimes, as well as the structures and transactions MNEs employ to organise their business operations. If uniformly adopted, the solutions proposed by the OECD might well be effective in curbing the double deduction (DD) or deduction/non-inclusion (D/NI) transactions described in the Drafts. Regrettably, some of the suggested solutions are overbroad and administratively unworkable.

Hybrid entities serve a variety of commercial purposes. Thus, the scope of this action should be limited to the use of hybrid entities or arrangements that are inappropriate or abusive, based on objective criteria and bright-line tests. This would permit MNEs to use hybrid entities or arrangements in other cases. The recommendations in the Discussion Drafts, and in particular the Domestic Draft, are regrettably not limited to inappropriate or abusive cases. Indeed, the recommendations would include in their scope transactions that take place between unrelated parties in certain instances, which is overbroad an unnecessary.

Need for Consensus Approach

To be successful, BEPS Action 2 on hybrid mismatches requires a consensus approach. More than any other action in the Action Plan, hybrid mismatch transactions will merely migrate to those nations that fail to adopt the final recommendations or adopt them piecemeal.[2]

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[1] Our comments focus primarily on the Domestic Draft's recommendations. Brief comments on the Treaty Draft are on page 10.

[2] The Domestic Draft recognises this problem and states that it "recommends that every jurisdiction introduce[] a complete set of rules that are sufficient to neutralise the effect of the hybrid

This is especially the case for imported mismatches and reverse hybrids, which also present the more vexing administrative and compliance issues.[3] While planning involving hybrid instruments or entities may become more difficult and therefore less prevalent, it will continue and eventually will undermine the objectives of the countries that adopt the OECD's recommendations. Indeed, there is seemingly no mechanism to encourage countries to adopt the Discussion Drafts' recommendations about hybrid mismatch arrangements. Perhaps this will be addressed under BEPS Action 5 regarding harmful tax practices.

Even if countries uniformly adopt the Domestic Draft's recommendations, differences regarding the timing of when each country implements the recommendations will by itself lead to mass confusion and uncertainty. Thus, the recommendations should be adopted as nearly simultaneously as possible to avoid any such confusion or uncertainty. The OECD could recommend that the rules for domestic law only go into effect after a critical mass of countries has implemented the rules.

Further, the Domestic Draft presumes that there will be a high degree of co-ordination and communication between countries in the implementation of the domestic recommendations and the primary response and defensive rules. Owing to the complexity of the rules and varying fiscal objectives in each taxing jurisdiction, it is highly unlikely that there will be a consistent approach in the interpretation and application of the often overlapping rules, leading to pervasive double taxation. Indeed, there will be significant incentives for tax authorities to routinely assert the defensive rule without inquiring whether the primary rule has been applied. If a country were to discover that another country denied a deduction in a DD transaction, which country will ultimately permit the deduction and thus reduce its tax base? We submit that neither jurisdiction will readily recede to the other, even in cases where they have adopted the Domestic Draft's recommendations, leaving the taxpayer with no deduction anywhere.

Similarly, TEI is concerned that the uncoordinated use of the secondary measure by the recipient country in the described D/NI structures could easily lead to double taxation. Given that the D/NI structures includes a foreign income pick-up plus a timing benefit only, the indiscriminate use of income recognition whenever a D/NI structure is suspected could easily lead to double taxation. With respect to the primary response, a denial of the deduction may not be warranted in many cases and will lead to disputes with local tax authorities on audit, especially if the proof that the otherwise deductible payment has been included in the recipient's income is not accepted.

As a result, resolving the inconsistencies that will arise where different hybrid mismatch "remedies" are applied will put even more pressure on the competent authority process, which

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mismatch on a stand-alone basis, without the need to rely on hybrid mismatch rules in the counterparty jurisdiction." Domestic Draft at p.11.

[3] *Id*. at p.56-66.

seems to be the "catchall" solution to the difficulties that will arise when implementing the Action Plan's recommendations.

Impact of Deferral/Timing Differences

The Domestic Draft states that its rules do not apply to timing differences.[4] Yet, the tax savings in several of the examples of targeted transactions seem to result from timing differences or tax deferral. For example, the Domestic Draft describes a share subscription with a deferred purchase price, which is treated as giving rise to a deductible expense for a subscriber and a non-taxable receipt for the share issuer.[5] In this case gain will eventually be recognised because of the basis reduction in the shares due to the deduction; denying the deduction would merely accelerate the timing for tax purposes. Thus, in timing or deferral structures the delayed or deferred income will eventually be taken into account and taxed. If the deduction were denied at the inception of the transaction, then double taxation would result. TEI recommends that these kinds of deferral and timing differences be excluded from the scope of the proposed rules. If the transactions are not merely timing and deferral transactions, but are truly D/NI transactions, then the Domestic Draft should more fully describe the targeted transactions to allay confusion.

Targeted Approach of Recommendations and "Top-Down" *vs*. "Bottom-Up"

TEI commends the OECD for its approach of targeting only the tax effects of the use of hybrid mismatches rather than recharacterising the instruments or entities underlying the mismatch. That is, denying a deduction or forcing an inclusion solely for the tax effects that arise from the mismatch rather than requiring that a financial instrument be treated as debt for all tax (and other) purposes (or recharacterising a fiscally transparent entity as opaque in all cases) is an appropriately narrow approach. TEI also commends the OECD for not recommending a general anti-abuse rule to address hybrid mismatches. Such a rule would create unnecessary uncertainty and hinder economic growth.

With respect to the scope of the hybrid financial instrument rule, the Domestic Draft posits two possible approaches: a "top-down" approach and a "bottom-up" approach.[6] The top-down approach would apply to all hybrid mismatches, and then provide certain exceptions (*e.g.*, for widely-held and/or publicly traded instruments), and also exceptions to the exceptions (*e.g.*, excepted transactions entered into by related parties).[7] The bottom-up approach would only apply to instruments held between related parties (including parties acting in concert) and

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[4] *See* Domestic Draft at p.26.

[5] *See* Domestic Draft at p.20. Other transactions described on page 20 also appear to result in timing differences or tax deferral.

[6] *See* Domestic Draft at p.32-42.

[7] *Id*. at p.38.

hybrid financial instruments entered into as part of a "structured" arrangement.[8] TEI strongly recommends that the OECD adopt the bottom-up approach.

An approach that applies to any and all hybrid financial instruments (other than a narrow class of excepted transactions) is simply unworkable for the reasons detailed in the Domestic Draft. As the Draft notes, under a top-down approach the "hybrid mismatch rule could apply . . . to any debt instrument that is held cross border (whether on initial issuance or following a transfer)."[9] This is problematic given the scope of today's global capital markets and cross-border investment flows. The Domestic Draft seems to recognise this, noting that the top-down approach would "impose compliance obligations on every person who is a party to an instrument unless those instruments are carved out of scope."[10]

A primary underlying issue is that while it is appropriate to require holders or issuers of financial instruments to determine the proper tax treatment of the instruments under the tax laws of the holder's or issuer's respective jurisdictions, it is not appropriate to require them to determine the tax treatment in the counterparty's jurisdiction (or potentially multiple jurisdictions if there is more than one foreign holder). As the Domestic Draft notes, the latter would require obtaining foreign tax advice on the treatment of the instrument in every counterparty jurisdiction, which would be an expensive and time consuming process. Moreover, holders would have to obtain information from the issuer, which may or may not be readily available or reliable. These complications only increase when an instrument is transferred from one holder to another in a different jurisdiction, which may create a hybrid mismatch when there was not one when the instrument was first issued.

While the bottom-up approach is more workable from an administrative and compliance standpoint, it has its own deficiencies. First, the ten percent threshold for determining whether parties are related is too low. The draft describes such holders as "non-portfolio investors." Hence, it appears this percentage was selected because it is generally the ownership threshold for determining when the "portfolio interest" exception from withholding taxes on interest no longer applies. (In other words, many countries exempt from withholding taxes interest payments to foreign holders where the holder owns less than ten percent of the issuer.) If the assumption is correct, the Domestic Draft regrettably proceeds from the mistaken premise that a ten-percent holder will in all cases be able to obtain the information necessary to determine the application of the hybrid financial instrument rule. In many cases, obtaining such information will be difficult, perhaps impossible, for a ten-percent holder. TEI recommends that the OECD use an ownership threshold of 50 percent or more, which is generally the threshold used to determine relatedness for transfer pricing purposes.

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8 *Id*. at p.34.

9 *Id*. at p.39.

10 *Id*.

Second, the rule for determining when persons are considered to act in concert is overbroad. The general rule provides that "a person who acts together with another person in respect of ownership or control of any voting rights or equity interests will be treated as owning or controlling all the voting rights and equity interests of that person."[11] Persons will be treated as acting together with respect to ownership and control of voting rights and/or equity interests if, among other things, the "ownership or control of any such rights or interests are managed by the same person or group of persons."[12] TEI recommends narrowing this portion of the rule with respect to when persons will be treated as "acting together." As written it appears to apply to all of the funds that are managed by the same investment company and to all of the trusts managed by the same trust company. TEI recommends that this portion of the "acting in concert" rule include a requirement that a primary consideration to invest in an instrument was to obtain a DD or D/NI tax benefit.

A final administrative issue, which would apply under either the top-down or bottom-up approach, is that modifying the tax effects of hybrid mismatches raises complications for financial reporting purposes. An instrument that is generally debt for tax purposes is expected to produce deductible interest payments for financial reporting purposes. Under the proposed rules, however, the interest payments may not be deductible depending on the identity and residence of the holder of the instrument (*e.g.*, Is the holder related or unrelated for purposes of the rule? In which jurisdiction does the holder reside?). Since the holder of an instrument can readily change, the compliance challenges for subsequent holders of more-than-10-but-less-than-50-percent interest will be exacerbated. At a minimum, the final rule should more closely align the definition of relatedness with that of "control" used for consolidated financial reporting purposes.

Definition of "Exemption"

Among the primary targets of the Domestic Draft are deductible payments that are "not included in ordinary income of the holder's jurisdiction."[13] For this purpose, "ordinary income . . . means income that is subject to tax at the taxpayer's full marginal rate and does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular categories of payments (such as credits for underlying tax paid by the issuer)."[14]

This definition, while helpful, leaves certain questions unanswered. For example, is an exempt dividend payment that is only 95 percent "exempt" (*i.e.*, five percent taxable) considered exempt under this rule? Similarly, is a payment that is subject to a five-percent rate of tax considered to have been "incorporated into a calculation of the recipient's net income under the laws of the relevant tax jurisdiction" as required by the Draft?[15] What if the payment

11 *Id*. at p.35.

12 *Id*.

13 *Id*. at p.27.

14 *Id*.

15 *Id*.

is untaxed as a result of the distributee's (or payee's) unrelated foreign tax credits (*i.e.*, credits that are not for the underlying tax paid or withheld by the dividend payer)? How would temporary benefits be treated under this rule? For example, in 2004 the United States enacted a one-time tax incentive to encourage U.S. companies to repatriate tax deferred foreign earnings.[16] The tax incentive came in the form of an 85-percent deduction for certain dividends received from foreign subsidiaries. Thus, these dividends were generally subject to a marginal tax rate of 5.25 percent (15 percent of the 35 percent U.S. corporate tax rate). It seems that under the definition in the Draft the dividends were "incorporated into a calculation of the recipient's net income" under U.S. law as required, but the dividends could also be seen as benefiting from "other tax relief." In other countries, whether dividends are taxable depends on how and where the dividends arise. A dividend may be fully exempt if it is paid from a subsidiary in a treaty-partner country and is paid out of active income. But if the dividend is paid from a subsidiary in a non-treaty country, the dividend may be taxable if the underlying tax rate is less than the parent company's rate. It is not clear how the definition of ordinary income applies in these cases. Thus, TEI recommends that the OECD expand its discussion of what it means for income to benefit from any exemption, exclusion, credit, or other tax relief.

Bias against Internal Leverage

Many of the examples of tax planning through hybrid mismatches in the Domestic Draft involve either the use of internal leverage (*i.e.*, debt instruments) or examples where the leverage itself is a hybrid instrument (*i.e.*, the financing instrument between related parties is treated as debt in one jurisdiction and equity in another jurisdiction). Further, the recommendations under BEPS Action 4 will address base erosion issues that arise via interest deductions and other financial payments. In addition, statements from certain OECD officials have indicated that the OECD is contemplating imposing limits on the use of internal leverage by business, possibly by limiting such leverage by reference to the amount of the MNE group's third party debt.

TEI opposes limiting the amount of a MNE group's internal leverage by reference to the group's third party debt. Such an approach would only encourage an MNE to incur more external debt than it otherwise would. In addition, the approach would place some businesses at a significant commercial disadvantage *vis-á-vis* their competitors.

Responses to Selected Questions regarding the Domestic Draft

The Domestic Draft sets forth several specific questions for consultation.[17] Although we continue to study the questions, TEI's responses to certain questions are provided below:

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16 *See* 26 U.S.C. Sec. 965.

17 *See* Domestic Draft at p.78-79.

1. Design of Hybrid Mismatch Rules

Are the objectives and design principles of the hybrid mismatch arrangements clear? If further clarification is required, then where is this required and how could it best be provided?

It is clear that the objectives of the hybrid mismatch rules are, in general, to deny the benefits of DD and D/NI transactions. Further clarification could be provided by delineating how two countries that simultaneously apply their domestic anti-hybrid instrument rules can easily coordinate their application. More broadly, if there are specific hybrid mismatch transactions that the OECD is targeting and believes are harmful, those transactions should be explicitly listed and described in Domestic Draft to assist tax authorities in applying the rules and place taxpayers on notice that these transactions will be subject to the new anti-hybrid rules.

2. Hybrid Financial Instruments & Transfers

Is it clear what elements need to be present in order for the rules neutralising hybrid financial instruments or hybrid transfers to apply? Is the outcome of the rules' operation clear?

It is generally clear what elements need to be present for the anti-hybrid rules to apply. TEI commends the OECD for producing targeted rules that are generally precise, which is preferred to a recharacterisation approach or an anti-abuse rule. The outcome of the rules, however, is not always clear, creating a significant risk of double taxation from countries applying the rules without coordination or inconsistently with each other. Administering the rules will require tax authorities to be much more knowledgeable about the design, implementation, and application of foreign tax laws than such authorities are currently. Misunderstandings of foreign tax law will inevitably lead to disputes and controversy.

This part [of the Domestic Draft] includes a number of examples: (a) What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties position?

As mentioned above, a commercial difficulty in the application of the hybrid rules is their impact on financial accounting when the hybrid rules, for example, deny a deduction. While this difficulty may be manageable in a related party transaction, it will be exacerbated when the parties lack the necessary information to determine the application of the hybrid rules, such as when an instrument is transferred between holders. Indeed, the correct application of the rules may not be determined until after a competent authority or court proceeding. The uncertainty in such a case is caused by the issuer's lack of information about an unrelated holder (or holders), and would not be caused by the application of the hybrid rules (*i.e.*, it is a factual uncertainty, not a legal one). Thus, this may be yet another situation where the financial accounting rules require taxpayers to book a reserve until the necessary information is acquired. While this would not be an unusual result for financial reporting

purposes, taxpayers prefer to be able to accurately reflect the tax consequences of their transactions in their financial statements on a timely basis.

3. Hybrid Entity Payments

Is it clear what elements need to be present in order for the rules neutralising deductible hybrid entity payments to apply?

The use of hybrid entities is much more prevalent by MNEs headquartered in certain countries than those headquartered elsewhere. The domestic law of such countries classifies the entities, and the classification in turn may determine whether or when income is recognised or deductions permitted. In addition, the overall tax consequences of transactions using hybrid entities often depend on the nature of the underlying tax system. For example, if an MNE is headquartered in a country with a worldwide tax system, then the income of the MNE's foreign branches is immediately subject to current tax. In contrast, in a territorial or exemption system, the foreign branch income is exempt. In these circumstances, there is a potential for a "double inclusion" if the income is taxable locally and also in the MNE's home country (the inclusion would generally be mitigated by a credit for taxes paid in the foreign jurisdiction, but not always). Thus, the results of the application of the hybrid entity rules are dependent on the underlying tax system of the country applying the rule. In many cases the rules may work well, but in many cases they will not. The OECD should recognise that the rules it recommends to address the use of hybrid will not always produce uniform results.

Is the outcome of the rules' operation clear?

As noted, application of the hybrid entity payment rules poses a significant risk of double taxation because of differences in the underlying tax systems of certain countries, as well as inconsistent and uncoordinated application of the rules.

4. Imported Mismatches and Reverse Hybrids

How could an anti–abuse provision be drafted so that it prevents otherwise unrelated parties from entering into arrangements to exploit mismatch arrangements?

Anti-abuse rules are extremely difficult to apply consistently absent accepted and well-developed guidelines. In many cases, these guidelines consist of common law developed through court decisions across multiple decades. Anti-abuse rules and doctrines are therefore best left to local countries to adopt and implement, and even then only in narrowly targeted situations. Should the OECD decide to recommend an anti-abuse rule, it should only apply in narrowly targeted cases of abuse, and be accompanied by strict, bright line rules delineating when tax authorities may assert the rule.

TEI Comments on the Treaty Draft

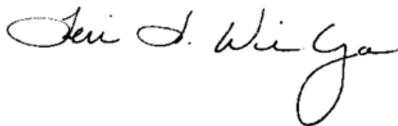
TEI opposes the use of bilateral tax treaties to address otherwise legal tax planning, as contemplated by the Treaty Draft. Tax treaties promote trade and direct foreign investment because they relieve double taxation; they have also been used increasingly to combat illegal fiscal evasion. The OECD's approach under this action and other action items in the Action Plan, such as Action 6 regarding tax treaty abuse, would expand the use of bilateral tax treaties into a new realm as tools for taxation where, in the absence of the treaty, such taxation would not otherwise occur.[18]

While TEI agrees that double non-taxation should be confronted, the OECD should be wary of making treaties a tool for combatting tax planning. In TEI's view, it will be difficult in many jurisdictions to effectively utilise treaties in this manner, either due to resistance by the legislature or the courts. That said, if a hybrid mismatch arises because of a treaty, then a simple remedy would be to change the relevant provisions of the treaty or prevent the treaty from being invoked in such cases. This is a more appropriate approach to such issues than turning treaties into an "all-purpose" tool to address disfavored tax planning. Use of tax treaties beyond this approach should be limited to reducing the difficulties that will arise when coordinating the anti-hybrid rules across two countries, such as by providing expedited mutual agreement procedures to resolve such issues and tie-breaker rules.

Conclusion

TEI appreciates the opportunity to comment on the OECD Discussion Drafts regarding hybrid mismatch arrangements. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +352 26 20 77 46, nickha@herbalife.com, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.



Terilea J. Wielenga
International President

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[18] TEI submitted comments to the OECD on BEPS Action 6: Prevent Treaty Abuse on 8 April 2014. TEI's comments are available at: http://www.tei.org/news/Pages/TEI-Comments-on-OECD-BEPS-Action-6-Prevent-Treaty-Abuse.aspx.