UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL

Mr. Pascal Saint-Amans
Director, Center for Tax Policy and Administration (CTPA)
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(*Pascal.SAINT-AMANS@oecd.org* / taxtreaties@oecd.org)

Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)

Dear Mr. Saint-Amans,

USCIB is pleased to have an opportunity to respond to the OECD's Discussion Draft on treaty issues involving hybrid mismatch arrangements.

The Discussion Draft would replace Article 1 with a new Article. Paragraph 1 of that new Article retains language saying the Convention applies to persons who are residents of one or both of the Contracting States. This seems inconsistent with new provisions intended to either resolve cases of dual residence or carve them out to the treaty.

The second paragraph states:

> [I]ncome derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. [In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State's right to tax the residents of that State.]

First, USCIB supports the inclusion of the so-called "saving clause". Including a saving clause may significantly reduce concern about inappropriate use of treaties by residents of one of the Contracting State and therefore require fewer anti-abuse rules in other contexts.

Second, USCIB believes this rule is not really an anti-hybrid rule at all, because the characterization of the entity in the source State should be irrelevant to the application of the rule. The basic issue is whether a source State should be giving a treaty benefit to a resident of the other state. The answer to this should be determined based on the shared expectations of the treaty partners. The recent Discussion Draft on Treaty Abuse makes this point quite clearly:

> Most of the provisions of tax treaties seek to alleviate double taxation by allocating taxing rights between the two States and it is assumed that where a State accepts treaty

> provisions that restrict its right to tax elements of income**, it generally does so on the understanding that these elements of income are taxable in the other State**.[1]

This language basically expresses the shared expectations of the treaty partners. That is, the source State will give up taxing rights when income is subject to tax in the residence State as the income of a resident. The only way to determine whether the residence State will tax someone as a resident of that State is to apply **its** rules including its rules on transparency and opacity. So, the inquiry should be does the residence State see the income (for tax purposes) in the hands of a resident? If it does then source State should grant benefits. If not, the source State should not grant benefits. We believe there has been confusion on this point because of the general rule of treaty interpretation that one applies the laws of the source State unless the context otherwise requires. It seems without doubt that in a case in which whether the income of a resident is subject to tax in the State of residence is an issue where the context requires that the laws of the state of residence must apply both to determine the type of entity that is being characterized (transparent or opaque) and whether that entity is a resident.

To illustrate this we use three examples below. All of the examples assume a treaty identical to the OECD Model between State A and State B. There is, therefore, a 10% rate of withholding on interest in lieu of the statutory 30% rate in State A.

Example 1. An entity resident in State A pays interest of 100 to a State B entity (Company) that is fiscally transparent under the laws of State B. Company is owned 60%[2] by qualified residents of State B that are not themselves fiscally transparent under State B law. The other 40% of Company is owned by persons that would not be entitled to benefits under a treaty with State A. In this case the State of residence (State B) treats the recipient of the income as fiscally transparent and therefore State B will consider that 60 of interest income is earned by residents of State B and will expect State A to provide the negotiated rate on interest income with respect to that income. State A should therefore collect 6 of tax from the State B residents and 12 of tax from the non State B residents. It is irrelevant for this purpose whether Company is treated as an entity which is not a resident of State B (which would be what Company is if State A treats it as opaque) or looking through to non-resident owners.

Example 2: An entity resident in State A pays interest of 100 to a State B entity (Company) that is treated as an entity under the laws of State B. Company is owned 60% by qualified residents of State B. The other 40% of Company is owned by persons that would not be entitled to benefits under a treaty with State A. Despite the split ownership Company satisfies the ownership/base erosion test of the applicable LOB article. In this case, because State B treats the Company as the taxable recipient of the income, State B will consider that all of the interest income to be earned by a resident of State B and will expect State A to provide the negotiated rate on interest income with respect 100% of that income. Further, State A should expect to

[1] OECD Discussion Draft, BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, paragraph 81, revised Commentary paragraph 15.2. Emphasis added.

[2] We have changed this to 60% both because it is easier to follow the numbers if the division of income is not 50/50 and because we will be applying the limitation on benefits provisions is the next example.

grant this benefit, because Company is an entity that is a resident of State B (and therefore subject to tax in State B), and is a qualified resident of State B. Therefore, State A should collect 10 of tax on the 100 of interest. This would be true regardless of whether State A treats Company as fiscally transparent or opaque. This is because this is a LOB issue, not an issue of fiscal transparency. A corporation that is a qualified resident in State B is entitled to treaty benefits. If State A is concerned that too much of Company is owned by non-State B residents that is an issue for the LOB provisions, not these rules. This should be clear because in a case in which both State A and State B consider the entity to be opaque, State A should have precisely the same concerns. An example along these lines concluding that treaty benefits are available on 100% of the income ought to be included in the revised Commentary.

Example 3: An entity resident in State A pays interest of 100 to a State B entity (Company) that is treated as an entity under the laws of State B. Company is owned 60% by qualified residents of State B. The other 40% of Company is owned by residents of State A. Despite the ownership by State A residents Company satisfies the ownership/base erosion test of the applicable LOB article. In this case, because State B treats the Company as the taxable recipient of the income, State B will consider that all of the interest income to be earned by residents of State B and will expect State A to provide the negotiated rate on interest income with respect 100% of that income. Thus, State A would be entitled to collect 10 of tax on this income. This would be true regardless of whether State A treats Company as fiscally transparent or opaque.

The treatment of Company as a qualified resident of State B and entitled to treaty benefits does not answer the question how State A should tax the State A residents. If State A treats Company as opaque, then residents of State A will only be taxable under domestic CFC or PFIC type rules. This is not a treaty issue. It is the same result that would occur if Company were an opaque entity resident in a non-treaty jurisdiction. The opaque entity in a non-treaty jurisdiction would pay 30 of State A withholding tax. The reduction of tax on a payment to an entity that is treated as opaque in its country of residence is an LOB issue and granting a benefit to an opaque entity that is a qualified resident under a tax treaty is consistent with the shared expectations of the treaty partners.

If State A treats Company as fiscally transparent (regardless of what State B does), then in a treaty with a saving clause, State A clearly has the ability to tax its residents as if the treaty had no effect. In that case, State A will tax its residents at the rates applicable to domestic residents. Forty percent of the interest income and State A tax of 4 should be allocable to the State A residents under appropriate partnership/fiscally transparent accounting rules, such that the State A tax (like any other tax incurred by Company) would flow-through to the State A resident and offset the State A tax ultimately due[3]. We believe this should be the result even in the case of a treaty without a saving clause, but it is certainly clear if there is a saving clause.

We recommend including an example along these lines in the Commentary to Article 1.

[3] This is not a foreign tax credit. State A would be giving a credit for State A tax paid to a resident of State A, so it is essentially a pre-payment of State A tax. This is simply the flow-through of a State A tax paid at the entity level to a State A partner/owner of a partnership/fiscally transparent entity.

Paragraph 26.6 of the Discussion Draft contains some language that USCIB believes is problematic.

> [I]f an entity is established in a jurisdiction from which a Contracting State cannot obtain tax information, that State would need to be provided with all the necessary information in order to be able to grant the benefits of the Convention. In such a case, the Contracting State might well decide to use the refund mechanism for the purposes of applying the benefits of the Convention even though it normally applies these benefits at the time of the payment of the relevant income.

USCIB is very concerned with this language because of its possible implications for investors, particularly portfolio investors. Delays, or possible denial of treaty benefits, may have a significant impact on cross-border investment. Business has been working with the OECD on the TRACE project to create a uniform system for granting benefits at source. Countries should be encouraged to engage in this process. TRACE stands for Treaty Relief and Compliance Enhancement. This is important because these concepts go together; granting treaty relief in appropriate cases at source will also enhance compliance. We believe that the OECD may be missing an opportunity to combine the work on AEOI based on the FATCA rules with the TRACE effort. If this opportunity is missed, we are concerned that countries and financial institutions will be reluctant to go back and modify systems to incorporate the treaty relief components of TRACE. We urge you to de-emphasize refund systems and work to incorporate appropriate treaty relief mechanisms in the ongoing AEOI work.

Comments on the Credit Method of Relieving Double Taxation

USCIB is concerned about the following statement in paragraph 22:

> [D]ouble non-taxation situations may arise in the application of the credit method…One example would be domestic law provisions that allow the foreign tax credit applicable to one item of income to be used against the State of residence's tax payable on another item of income. This is another situation where Contracting States should ensure that their tax treaties provide for the elimination of double taxation without creating opportunities for tax avoidance strategies.

The BEPS Action Plan recognizes that "taxation is at the core of countries sovereignty" and that countries have the right to establish their own tax rules.[4] Thus, countries may choose to relieve double taxation through an exemption/territorial system or a foreign tax credit system. Either of these choices is appropriate. A foreign tax credit system is a more precise method of relieving double taxation and will generally result in less untaxed income. Countries that have a foreign tax credit system need to balance the potential for cross-crediting with the administrative burden imposed by very restrictive foreign tax credit rules. If countries have a sovereign right to choose an exemption/ territorial system, then they may also appropriately choose a world-wide credit even though that might permit some cross-crediting of taxes from a

[4] OECD BEPS Action Plan, page 9.

high-tax jurisdiction against income earned in a low-tax jurisdiction.[5] There are a range of reasonable choices from which sovereign countries may choose to eliminate double taxation and they do not need to choose the narrowest option. USCIB is concerned that the Discussion Draft implies a treaty obligation to limit the foreign tax credit, so that the residence country would be required to collect tax to the extent that source country tax is relieved[6]. Tax treaties do not operate so precisely. The key issue is whether the income is subject to tax in the hands of a resident of the State of residence. Many residence State rules may result in the reduction or elimination of residence State tax. For example, if the company receiving the income has an operating loss, there may be no tax due. Foreign tax credit rules that permit cross-crediting are a reasonable approach and should not be precluded by overly restrictive treaty rules.

Sincerely,

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United States Council for International Business (USCIB)

[5] Indeed, the benefit of this cross-crediting really accrues to the other high-tax jurisdiction because it makes it less costly to invest in a high-tax jurisdiction if cross-crediting is permitted.
[6] US law generally creates a separate "basket" for income that is treated as foreign source under the treaty, but does not otherwise separately "basket" income that is foreign source without regard to the treaty.

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