TAKING ACTION AGAINST BASE EROSION PROFIT SHIFTING

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I. INTRODUCTION

With the explosion of globalization and the rise of multinational business entities (MNEs), an increasing number of opportunities are available for entities to minimize their taxable income by taking advantage of inconsistencies in federal tax laws.[1] Well-known companies, including Apple, Microsoft, Hewlett-Packard,

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[1] *Action Plan on Base Erosion Profit Shifting*, ORG. FOR ECON. COOPERATION & DEV., 7-8 (2013), http://www.oecd.org/ctp/BEPSActionPlan.pdf [hereinafter *Action Plan*].

Google, Amazon, IBM, and Caterpillar, have sought to lower their tax burdens by shifting profits to lower-tax jurisdictions, even if very little of the profit came from that jurisdiction.[2] It is estimated that more than $2 trillion is being kept overseas as companies look to minimize their tax bills.[3] The Organization for Economic Cooperation and Development (OECD) has taken steps to help combat this perceived tax avoidance, better known as base erosion profit shifting (BEPS).[4] The OECD has released an Action Plan on BEPS that contains 15 action items designed to target problem areas identified by the OECD.[5] The OECD has also authored multiple discussion drafts designed to accompany the Action Plan that provide more detailed explanation.[6] In essence, the OECD is trying to garner global unanimity in an effort to discourage profit shifting.[7] Although the OECD did a remarkable job on the proposals, and they may work very well in other jurisdictions, the United States might have a tough time implementing them given the way the United States taxes income globally.

This Note focuses on Action 2 of the OECD plan–"Neutralise the Effects of Hybrid Mismatch Arrangements"–and will take a look at the accompanying discussion drafts released by the OECD that expand on Action 2. More specifically, this Note discusses: (1) the international tax framework and the need for international corporate tax reform, drawing on recent examples from Apple and Amazon; (2) Action 2, hybrid mismatch arrangements, and the two accompanying Discussion Drafts addressing hybrid mismatch arrangements; (3) early adoption of the Action Plan as well as implications. Finally, this Note concludes by positing that while Action 2 and the Discussion Drafts are a good starting point for international corporate tax reform, the OECD's model is most likely not the best solution for the United States given the way the United States taxes income globally.

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[2] Maxwell Murphy, *OECD Takes Aim at Improper Profit Shifting*, WALL ST. J. (Sept. 16, 2014, 5:32 PM), http://blogs.wsj.com/cfo/2014/09/16/oecd-takes-aim-at-improper-profit-shifting/; *see also* Richard Rubin, *Cash Abroad Rises $206 Billion as Apple to IBM Avoid Tax*, BLOOMBERG, (Mar. 12, 2014), http://www.bloomberg.com/news/2014-03-12/cash-abroad-rises-206-billion-as-apple-to-ibm-avoid-tax.html.

[3] Tim Higgins, *Tim Cook's $181 Billion Headache: Apple's Cash Held Overseas,* BLOOMBERG, (July 22, 2015), http://www.bloomberg.com/news/articles/2015-07-22/tim-cook-s-181-billion-headache-apple-s-cash-held-overseas.

[4] *Action Plan, supra* note 1, at 11.

[5] *OECD Releases Action Plan on Base Erosion and Profit Shifting (BEPS)*, ERNST & YOUNG LLP (July 19, 2013), http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--OECD-releases-Action-Plan-on-Base-Erosion-and-Profit-Shifting--BEPS-.

[6] *Tax Policy Bulletin: OECD Releases Two Discussion Drafts on Hybrid Mismatch Arrangements,* PRICEWATERHOUSECOOPERS LLP*,* (Mar. 21, 2014), http://www.pwc.com/en_GX/gx/tax/newsletters/tax-policy-bulletin/assets/pwc-oecd-releases-two-discussion-drafts-hybrid-mismatch-arrangemen.pdf [hereinafter *Tax Policy Bulletin*].

[7] Richard Rubin, *Profit Shifting: Moving Profits to Cut U.S. Taxes*, BLOOMBERG (Aug. 4, 2015), http://www.bloombergview.com/quicktake/profit-shifting-avoid-tax.

II. LEGAL OVERVIEW

A. The International Tax Framework

In 2013, Bloomberg reported that tech giant Apple Inc. paid an effective corporate tax rate of just under 14% on its worldwide income, well below the standard U.S. corporate rate of 35%.[8] When testifying before Congress in May of 2013, Apple CEO Tim Cook stated that Apple paid the United States $6 billion in taxes the previous year at a tax rate of 30.5%.[9] While correct, his statements ignore Apple's overseas affiliates. Cook's 30.5% figure referred to pretax income of $19 billion, only about one-third of Apple's pretax income worldwide.[10] Apple's affiliate in Ireland reported another $30 billion of income[11] that was subject to Ireland's corporate tax rate of just 12.5%.[12] The complex arrangement of laws comprising the international tax framework often give rise to scenarios such as the one that brought Apple before Congressional leaders.

Jurisdictions can be categorized based on whether or not that jurisdiction taxes foreign income.[13] Today, 28 of the 33 OECD countries use a territorial tax system.[14] Under the territorial system, a corporation is taxed only on income earned in that jurisdiction.[15] Unlike many other OECD countries, the United States employs a worldwide taxation system, meaning corporations are taxed on all of its income earned both in the United States and abroad.[16] The corporation pays tax on foreign income when it is brought back into the United States, or

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[8] Jesse Drucker, *Apple Tax Rate Ignores Profit Shifting Offshore*, BLOOMBERG (May 22, 2013), http://www.bloomberg.com/news/articles/2013-05-23/apple-tax-rate-ignores-profit-shifting-offshore.

[9] *Id.*

[10] *Id.*

[11] *Id*.

[12] *Corporation Tax*, IRISH TAX AND CUSTOMS, http://www.revenue.ie/en/tax/ct/ (last visited Sept. 25, 2015) (explaining that the 12.5% tax rate applies to "trading income"—i.e. income that is not investment or some other form of passive income).

[13] Philip Dittmer, *A Global Perspective on Territorial Taxation*, TAX FOUND. (Aug. 10, 2012), http://taxfoundation.org/article/global-perspective-territorial-taxation.

[14] *The U.S. Tax Code: Love It, Leave It, or Reform It: Hearing Before the Comm. On Finance United States Senate*, 113 Cong. 11-12 (2014) (statement of Peter R. Merrill, Principal, PricewaterhouseCoopers LLP), http://www.finance.senate.gov/imo/media/doc/Testimony%20of%20Peter%20Merrill.pdf.

[15] *Territorial vs. Worldwide Taxation,* SENATE REPUBLICAN POL'Y COMMITTEE (Sept. 19, 2012), http://www.rpc.senate.gov/policy-papers/territorial-vs-worldwide-taxation.

[16] Dittmer, *supra* note 13.

"repatriated."[17] The respective benefits and drawbacks to the two different systems have long been the center of international tax policy debate.[18]

Under the current international tax environment, companies that have operations or affiliates in multiple tax jurisdictions may encounter tax rules that either overlap or result in income being deductible in multiple jurisdictions.[19] These two phenomena are known as double taxation or double non-taxation, and the latter is increasingly used to shrink an MNE's taxable income and is considered abusive.[20] Profits can also be shifted when an affiliate in the lower-tax jurisdiction provides cash through a loan for operations in the higher-tax jurisdiction rather than repatriating the cash.[21] By shifting profits to an offshore subsidiary in a lower-tax rate jurisdiction, companies can lower their overall effective tax rate and increase profits.[22] The OECD reports that a growing number of bilateral tax treaties help to address these inconsistencies across jurisdictions.[23] International pressure also caused low-tax jurisdictions such as Ireland to close some tax loopholes.[24] Still, many gaps in international taxation remain.[25]

The international tax framework in place today is in essence a competition-based model in which countries compete for investment income and tax revenue.[26] With communication and transportation costs plummeting globally, MNEs have expanded operations all over the globe.[27] Emerging economies such as China, India, and Brazil are eager to attract foreign investment to sustain their growth trajectory.[28] Often emerging economies design their tax laws to attract more international investment.[29] They hope to reap the benefits of the tax revenue

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[17] *Id*.

[18] SENATE REPUBLICAN POL'Y COMMITTEE, *supra* note 15.

[19] *Tax Policy Bulletin, supra* note 6.

[20] Yariv Brauner, *What the Beps?*, 16 FLA. TAX REV. 55 (2014).

[21] Kirsten Burmester & Stafford Smiley, *Overview of the OECD's Action Plan on Base Erosion and Profit Shifting*, 40 WGL-CTAX 49 (2013).

[22] Drucker, *supra* note 8.

[23] *Action Plan*, *supra* note 1, at 10-11.

[24] Sam Schechner, *Ireland to Close 'Double Irish' Tax Loophole*, WALL ST. J., (Oct. 14, 2014), http://www.wsj.com/articles/ireland-to-close-double-irish-tax-loophole-1413295755.

[25] *Action Plan*, *supra* note 1, at 10.

[26] Brauner, *supra* note 20, at 64-65.

[27] Steven Go & Joseph Wu, *Is International Tax Competition Really Harmful?*, PRICEWATERHOUSECOOPERS, (Oct. 2010), http://www.pwc.tw/en/topics/tax/taxation-20101010.html.

[28] Karl P. Sauvant et al., *Foreign Direct Investment by Emerging Market Multinational Enterprises, The Impact of the Financial Crisis and Recession and Challenges Ahead*, GLOBAL F. ON INT'L INV. (Dec. 7, 2009), http://www.oecd.org/investment/globalforum/44246197.pdf.

[29] Go & Wu, *supra* note 27.

that these operations generate.[30] A growing number of commentators argue that such tax competition is merely the byproduct of "structural changes in the global economy."[31] Proponents of the competition model are apprehensive about a global governance regime; they question the ability of countries to put aside their individual interests and work together collaboratively.[32]

B. The OECD Action Plan & Action 2

The competition-based paradigm is far from perfect. While low taxation is not necessarily bad, OECD argues that separating taxation from the economic activities that generate it "could harm competition, economic efficiency, transparency and fairness."[33] The multiple problems implicated by BEPS are so important that the OECD has developed and released an Action Plan for Base Erosion and Profit Shifting,[34] a plan world leaders endorsed at the 2013 G20 summit.[35] As markets drag through a sluggish world economy, OECD calls for closer collaboration between jurisdictions.[36] The Action Plan proposes both domestic rules and new model treaties that keep tax revenue in the countries in which the profits originated.[37] In short, the Action Plan seeks to spur a movement where countries work together to help close loopholes and ensure "coherence of corporate income taxation at the international level."[38]

The Action Plan includes five broad aims: (1) to address the digital economy's tax challenges, (2) to establish the international coherence of corporate income taxation, (3) to restore the full effects and benefits of international tax standards, (4) to ensure transparency, and (5) to swiftly implement the suggested measures.[39] Working within these five aims, the plan sets forth 15 specific action items, each with specific step(s) that the jurisdictions should take.[40] OECD claims that the overall world economy will improve by the elimination or minimization of double non-taxation and instances of "low or no taxation associated with

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30 *Id*.

31 *Id*.

32 Brauner, *supra* note 20, at 66.

33 *Action Plan*, *supra* note 1, at 15.

34 *Id.* at 11.

35 Theophilos Argitis & Scott Rose, *G-20 Nations 'Fully Endorse' OECD Action Plan on Tax Evasion,* BLOOMBERG (July 20, 2013), http://www.bloomberg.com/news/articles/2013-07-20/g-20-nations-fully-endorse-oecd-action-plan-on-tax-evasion-1-.

36 *Action Plan*, *supra* note 1, at 7.

37 *Id.* at 15.

38 *Id.* at 13.

39 Tim Anson et. al., *BEPS: OECD and Ways & Means Start Taking Action*, 24 J. OF INT'L TAX'N. 45, 46 (2013).

40 *Action Plan*, *supra* note 1.

practices that artificially segregate income tax from the activities that generate it."[41] Adoption of the OECD actions may nudge global taxation toward this goal.

One of the most crucial actions of this Plan is Action 2, "Neutralise the Effects of Hybrid Mismatch Arrangements." Hybrid mismatch arrangements are defined as "arrangements that utilize hybrid elements in tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes of payments made under those arrangements."[42] Therefore, this action proposes model tax treaty revisions needed to combat the mismatch of tax outcomes that lead to taxable base erosion. While difficult to implement, the second Action could be a driving force behind reform of international tax treaties and domestic tax policies if some of the suggested provisions are adopted. Action 2 proposes the following changes:

(i)	"Amendments to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly;"
(ii)	"Domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor;"
(iii)	"Domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules);"
(iv)	"Domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction;" and
(v)	"Where necessary, guidance on coordination or tiebreaker rules if more than one country seeks to apply" the above rules to a transaction or structure.[43]

Table 1

The proposed changes are both global in nature (revising the OECD Model Tax Convention) and country-specific (domestic law provisions that avoid conflicting outcomes across jurisdictions).

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[41] *Id.*

[42] *OECD Releases Report under BEPS Action 2 on Hybrid Mismatch Arrangements*, ERNST & YOUNG LLP (Sept. 24, 2014), http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--OECD-releases-report-under-BEPS-Action%C2%A02-on-hybrid-mismatch-arrangements [hereinafter *OECD Releases Report*]. *See infra* Section IID.

[43] *Action Plan, supra* note 1, at 15.

C. Action Item 2 – The Discussion Drafts

On March 19, 2014, the OECD released two discussion drafts pertaining to Action Item 2.[44] The discussion drafts expand on the ideas expressed in Action 2 of the Plan.[45] The drafts further define hybrid mismatch arrangements as the result of "a difference in the characterization of an entity or arrangement under the laws of two or more tax jurisdictions that result in a mismatch in tax outcomes."[46] The discussion drafts targeted two specific outcomes that result from mismatch arrangements: payments that give rise to deductions in multiple jurisdictions (double deduction or DD) and payments that are deductible in the payer's jurisdiction but the payment is not recognized as income in the recipient's jurisdiction (deduction/no inclusion or D/NI).[47]

The first discussion draft, the "Domestic Laws draft," proposes numerous changes to domestic laws to combat the effects of BEPS and these mismatched arrangements.[48] The OECD puts forth some "design principles" that should be integrated into the development of domestic rules. The draft rules should:

> (a) Operate to eliminate the mismatch without requiring the jurisdiction applying the rule to establish that it has 'lost' tax revenue under the arrangement; (b) be comprehensive; (c) apply automatically; (d) avoid double taxation through rule co-ordination; (e) minimize the disruption to existing domestic law; (f) be clear and transparent in their operation; (g) facilitate co-ordination with the counterparty jurisdiction while providing the flexibility necessary for the rule to be incorporated into the laws of each jurisdiction; (h) be workable for taxpayers and keep compliance costs to a minimum; and (i) be easy for tax authorities to administer.[49]

The OECD identifies three key hybrid mismatch outcomes it is trying to minimize through domestic law reform: hybrid financial instruments (including

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[44] *Tax Policy Bulletin*, *supra* note 6.

[45] *Id*.

[46] *Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)*, ORG. FOR ECON. COOPERATION AND DEV. 4, 8 (Mar. 19-May 2, 2014), http://www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf [hereinafter *Domestic Laws*].

[47] *BEPS Action 2: Hybrid Mismatch Arrangements,* DELOITTE LLP (Mar. 26, 2014), http://www2.deloitte.com/content/dam/Deloitte/ie/Documents/Tax/2014-deloitte-ireland-beps-action-2-hybrid-mismatch-arrangements.pdf.

[48] *Tax Policy Bulletin*, *supra* note 6.

[49] *Domestic Laws, supra* note 46, at 5.

transfers),[50] hybrid entity payments,[51] and reverse hybrid and imported mismatches.[52] The OECD argues each has contributed greatly to the base erosion profit-shifting problem.[53]

The OECD also introduces the idea of "linking rules" in the Domestic Laws draft. The tax treatment of an entity, instrument, or transfer in one jurisdiction is "linked" to the treatment of the same entity, instrument, or transfer in another jurisdiction.[54] Thus, tax rules of the different jurisdictions are "linked" and mismatches can be avoided.[55] The OECD also recognized that seamless linking of two different jurisdictions' rules could be difficult, so it proposed a "defensive rule" that would act as a fallback when the primary rule did not apply in one jurisdiction.[56] In terms of the scope of these rules, the draft suggests both a "bottom up" approach and a "top down" approach to implementation.[57] In the "top down" approach, the rules are applied broadly to *all* hybrid mismatches with exceptions carved out for specific instances where it would be "impossible or unduly burdensome for the taxpayer to comply."[58] In contrast, the "bottom up" approach involves looking at the most significant transactions on a case-by-case basis with an emphasis on tax policy implications.[59]

The second discussion draft evaluates current tax treaties and proposes some new treaty language designed to clarify treatment of dual-resident (hybrid) entities (the "Treaty draft").[60] More specifically, the Treaty draft is almost exclusively suggesting changes to the OECD Model Tax Convention.[61] The OECD developed the Model in 1992, which often served as the basis for the development of new international tax treaties, particularly when there are concerns about double taxation across jurisdictions.[62] The Treaty draft was

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[50] *Id.* at 15 ("[W]here a deductible payment made under a financial instrument is not treated as taxable income under the laws of the payee's jurisdiction . . .").

[51] *Id*. ("[W]here differences in the characterization of the hybrid payer result in a deductible payment being disregarded or triggering a second deduction in the other jurisdiction . . .").

[52] *Id.* (explaining that payments made to an intermediary are not taxable on receipt due to a hybrid effect.).

[53] *Tax Policy Bulletin*, *supra* note 6.

[54] *Domestic Laws, supra* note 46, at 11.

[55] *Id.*

[56] *Id.* at 16.

[57] *Id*. at 33.

[58] *Id.* at 55.

[59] *Domestic Laws, supra* note 46, at 33.

[60] *Tax Policy Bulletin*, *supra* note 6.

[61] *OECD Discussion Drafts for Action 2 (Neutralise the Effects of Hybrid Mismatch Arrangements)*, KPMG LLP (Mar. 20, 2014), http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Documents/14154-analysis.pdf.

[62] *OECD Model Tax Convention on Income and on Capital: An Overview of*

written to work in concert with the Domestic Laws draft, and it covers three main topics: (1) use of dual resident entities to obtain the benefits of treaties unduly, (2) use of transparent entities to obtain the benefits of treaties unduly, and (3) interaction between the recommendations included in the Domestic Law draft and the provisions of tax treaties.[63]

Consistent with the OECD Model Tax Convention, the Treaty draft suggests that dual resident entities' tax treatment be determined on a case-by-case basis.[64] Second, the use of transparent entities, the Treaty Draft proposes:

> Income 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.[65]

When considering the interaction between current tax treaties and the recommendations in the Domestic Laws draft, the OECD drafters conclude generally that there is no conflict or inconsistencies between the proposals of the Domestic Laws draft and the utilized provisions of the Model Convention.[66] However, two interaction issues raise problems. The Domestic Laws draft suggests denying deductions and/or forcing income inclusion for hybrid instruments and payments.[67] The Model Convention suggests a tax on a nonresident with no permanent establishment in the jurisdiction; this varies from the forced income inclusion or deduction denial of the more recent discussion draft.[68] Also, anti-discrimination provisions in the Model Convention could conflict with some of the recommendations intentionally directed at hybrids.

Available Products, ORG. FOR ECON. COOPERATION AND DEV., http://www.oecd.org/ctp/treaties/oecd-model-tax-convention-available-products.htm (last visited Sept. 25, 2015) [hereinafter *OECD Model Tax Convention*].

[63] *Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)*, ORG. FOR ECON. COOPERATION AND DEV. (Mar. 19 -May 2, 2014), http://www.oecd.org/ctp/treaties/hybrid-mismatch-arrangements-discussion-draft-treaty-issues-march-2014.pdf [hereinafter *Treaty Issues*].

[64] *Id.* at 5.

[65] *Id.* at 7.

[66] *Tax Policy Bulletin*, *supra* note 6.

[67] *Id.*

[68] *Id.*

D. Defining Hybrid Mismatch Arrangements

According to the OECD, the key elements of a hybrid mismatch arrangement are as follows: (i) the arrangement results in a mismatch in the tax treatment of payment; (ii) the arrangement contains a hybrid element; (iii) the hybrid element is the cause of the mismatch; and (iv) the mismatch in tax outcomes lowers the aggregated tax paid by the parties to the arrangement.[69]

Hybrid elements, as referenced in item (iii) above, are characterized either as hybrid entities or hybrid instruments.[70] The IRS defines a hybrid entity as an "entity that is not taxable as an association for Federal tax purposes, but is subject to an income tax of a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis."[71] Hybrid financial instruments are explained in greater detail below.

In summary, hybrid mismatch arrangements can contain any number of elements that cause conflicting tax outcomes in different jurisdictions, leading to arbitrage and an erosion of the United States's MNE's taxable base. As previously mentioned, the OECD categorizes these types of hybrid mismatch arrangements: (1) hybrid financial instruments (including transfers), (2) hybrid entity payments, and (3) reverse hybrids/imported mismatches.[72] Outcomes from these categories are generally characterized as DD (double deduction) or D/NI (deduction/no inclusion) events.[73]

1. Hybrid Financial Instruments (Including Transfers)

Hybrid financial instruments usually lead to D/NI outcomes because the payment is deductible in the payer's jurisdiction, while the receipt of the payment is not taxed as income in the payee's jurisdiction.[74] A number of reasons for the payment being deductible for the payee include exemptions, exclusions, or indirect tax credits that may apply.[75] See the figure below for a simplified illustration.[76]

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69 *Id*.
70 *Id.*
71 26 C.F.R. §1.1503(d)-1(b)(2)(3) (2015).
72 *Tax Policy Bulletin*, *supra* note 6.
73 *OECD Releases Report, supra* note 42.
74 *Domestic Laws, supra* note 46, at 20.
75 *Tax Policy Bulletin*, *supra* note 6.
76 *Domestic Laws, supra* note 46, at 19.

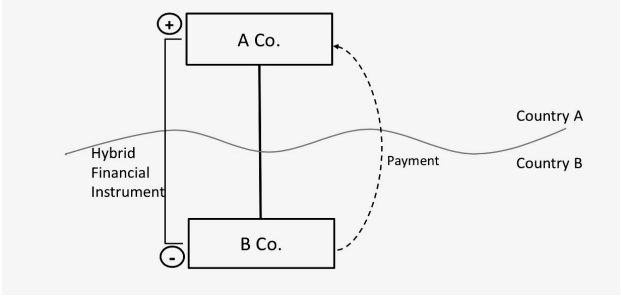

Figure 1

In this example, Company B borrows money from Company A, for which Company B pays interest to Company A. Company B's jurisdiction allows deductions for interest payments. Company A's jurisdiction has tax rules that exclude interest income for payments received from the financial instrument. The D/NI outcome that the OECD hopes to prevent is achieved as the taxable base is lowered for both of these companies. The OECD proposes draft rules that apply when differences in characterization of the financial instrument for tax purposes exists in the respective jurisdictions, as well as draft rules that apply when a particular payment (i.e. the interest payment in the example above) is given different tax treatment in these jurisdictions.[77]

Hybrid transfers are usually collateralized loans or derivative transactions where "the counterparties to the same arrangement in different jurisdictions are both treated as owner of the loan collateral or the subject matter of the derivative," leading to D/NI outcomes and subsequent surplus deductions.[78] The OECD recommends the following draft rules to minimize hybrid financial instruments and transfers. As a primary rule, "jurisdictions should deny a deduction for any payment made under a hybrid financial instrument to the extent that the payee does not include the payment as ordinary income."[79]

A secondary draft rule would "require the payee to include any payment as ordinary income to the extent that the payer is entitled to claim a deduction for such payment (or equivalent tax relief)."[80] Referring again to the above example, if Company B's jurisdiction adopted these proposed draft rules, Company B would be denied a deduction for the interest payments made to Company A. However, if it did not adopt the primary draft rule in B company's jurisdiction, then Company A's jurisdiction could apply the secondary draft rule. Company A

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77 *Tax Policy Bulletin, supra* note 6.
78 *Id.* at 3-4.
79 *Domestic Laws, supra* note 46, at 25.
80 *Id*.

would have to include the interest payments in its ordinary income, whether that happened through denial of deductions or otherwise.[81]

2. Hybrid Entity Payments

In this category of hybrids, the OECD targets arrangements with a hybrid entity designed to achieve a DD outcome ("deductible hybrid payments") or a D/NI outcome ("disregarded hybrid payments") from a single payment.[82] In this category, the hybrid treatment of the entity causes these results.[83]

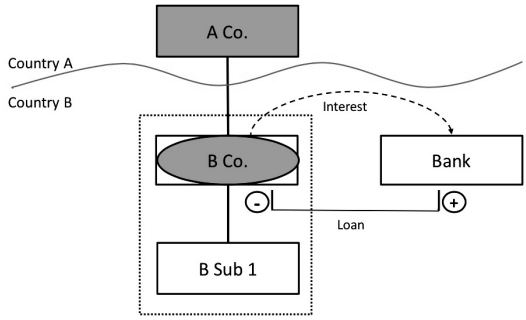

Figure 2

In the above scenario,[84] Company A is an investor in Company B. Company B is treated as a transparent entity under the tax laws of Country A, but as non-transparent under the laws of its own jurisdiction. Therefore, Company B is a hybrid entity. Because Company B is a transparent/disregarded entity in Country A's jurisdiction, Country A considers Company A the borrower under the loan. As a result, Company A gets a deduction for interest payments and Company B gets an interest deduction in its jurisdiction. The result is a DD outcome.[85] Taking the scenario even further, Company B's interest payments will offset the tax burden of the profits of B's subsidiary (sub 1).[86] This scenario simplifies the way hybrid entities can be used to erode the taxable income of a MNE,[87] and the discussion draft includes far more complicated scenarios.[88]

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81 *Tax Policy Bulletin*, *supra* note 6.
82 *Id*.
83 *Id.*
84 *Domestic Laws, supra* note 46, at 44.
85 *Id*.
86 *Tax Policy Bulletin*, *supra* note 6.
87 *Domestic Laws, supra* note 46.
88 For additional discussion of these more complicated scenarios, including

Hybrid entities can also be used to achieve D/NI outcomes. In the scenario below, the same structure in Figure 2 is used again.[89]

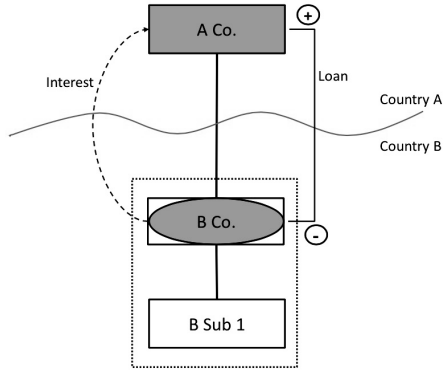

Figure 3

However, Company B is borrowing from Company A instead of a bank. Because Company B is transparent in Country A's jurisdiction, the loan, including interest, is ignored. However, because Company B is non-transparent in Country B, the loan is recognized, and Company B may get a deduction. Thus, the result is D/NI.[90] This deduction can be used to offset the tax burden of B's subsidiary.[91]

The discussion drafts recommend two sets of draft rules for each of the DD and D/NI outcomes that result from hybrid entity payments. To minimize the DD effect, the primary draft rule suggests "the duplicate deduction that arises in the investor jurisdiction should be denied to the extent it exceeds the taxpayer's dual inclusion income[92] for the same period."[93] The secondary rule proposes "the deduction for a hybrid payment should be denied in the subsidiary jurisdiction to the extent it exceeds a taxpayer's dual inclusion income for the same period."[94] In the event of a D/NI outcome, the OECD proposes the following primary rule: "deduction granted by the payer jurisdiction for a disregarded payment should not exceed a taxpayer's dual-inclusion income for the same period."[95] In other words,

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structures like partially owned entities, permanent establishments, dual resident entities, etc., which are beyond the scope of this Note, see *Domestic Laws, supra* note 46.

89 *Id*. at 48.

90 *Id.* at 47-48.

91 *Id.* at 48.

92 *Id*. at 49, 51 (explaining that "dual inclusion income" as used in the above scenarios describes income that has been taxed in both jurisdictions).

93 *Domestic Laws, supra* note 46, at 51.

94 *Id*.

95 *Id*.

any deduction beyond the payer's "dual inclusion income" will be denied. The secondary rule proposes "the payee should be required to include, as ordinary income, in the payee jurisdiction, any disregarded payment to the extent the payer's deductions for such payment in the payer jurisdiction exceed the payer's dual inclusion income for the same period."[96] Thus, if the primary rule does not apply, the payee's excess deductions should be included in the payee's income.[97]

3. Imported Mismatches & Reverse Hybrids

Both imported mismatches and reverse hybrids can be used to achieve D/NI outcomes.[98] Imported mismatches are arrangements created by a hybrid mismatch arrangement that can be moved, or "imported" into a third jurisdiction by means of a financing instrument.[99] Figure 4 illustrates an imported mismatch.[100]

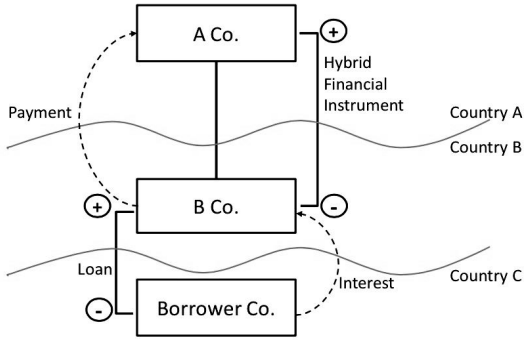

Figure 4

In the above example, Company A lends money to Company B (-) using a hybrid financial instrument. Company B makes interest payments to Company A (+). The payments are deductible in Country B's jurisdiction but not included in Company A's income in Country A. Meanwhile, Borrower Company is in a separate tax jurisdiction—Country C. Borrower Company borrows money from Company B. The Borrower Company's interest payments are deductible in Country C and taxable in Country B. Therefore, a D/NI outcome results because the Borrower Company's interest payments are deductible but are not taxable

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96 *Id.*
97 *Tax Policy Bulletin*, *supra* note 6.
98 *Id.*
99 *Id.*
100 *Domestic Laws, supra* note 46, at 58.

income for Company A.[101] The entire arrangement has no net effect on Company B, who will get a deduction for interest payments made to Company A but will be taxed on interest income from the Borrower Company.[102]

Reverse hybrids are often viewed as a subcategory of imported mismatches and also achieve D/NI outcomes.[103] The following scenario illustrates reverse hybrids: Company A owns Company B, which is treated as transparent in its own jurisdiction, (Country B), but non-transparent in Company A's jurisdiction, (Country A). Company B makes a loan to another entity, Company C. In certain instances, Company C's interest payments could be deductible in Company C's jurisdiction, but the interest is not recognized in either Company A's or Company B's jurisdiction (a D/NI outcome).[104]

The OECD proposes tax law changes to eliminate this result. For a primary rule, the investor (Company A) should include interest income from the arrangement.[105] As a secondary rule, the intermediate jurisdiction (Company B's jurisdiction in the example) should tax the income of the intermediary entity (Company B).[106] Additionally, the Domestic Law draft recommends a defensive rule as a fallback when neither of the above rules applies.[107] According to the defensive rule, the deduction is denied to the taxpayer when payments to a reverse hybrid or imported mismatch arrangement result in non-inclusion for the taxpayer or are offset by an expenditure of the hybrid mismatch arrangement.[108]

E. Amazon's Luxembourg Problem

Deeper exploration of the recent tax avoidance schemes by Amazon, Luxembourg, and other EU member states can help shed light on the current tax climate in the EU. As the Financial Times reported on January 15, 2015, European Commission (EC) investigators are heavily scrutinizing a corporate tax deal between Luxembourg and online retailer Amazon.[109] The EC alleges that under the deal, Luxembourg provided favorable tax treatment when it "artificially lowered and capped" Amazon's tax bill, thereby violating EU law.[110] The EC

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101 *Id*.
102 *Id*.
103 *Tax Policy Bulletin*, *supra* note 6.
104 *Id*.
105 *Domestic Laws, supra* note 46, at 61.
106 *Tax Policy Bulletin, supra* note 6.
107 *Domestic Laws, supra* note 46, at 61.
108 *Id*.
109 *See* Alex Barker, *European Commission Lays Bare Amazon Tax Deal with Luxembourg*, FIN. TIMES (Jan. 16, 2015), http://www.ft.com/cms/s/0/733c68bc-9d4d-11e4-9b22-00144feabdc0.html#axzz3nYZfSuKJ.
110 *Id*.

believes that Luxembourg "deviated from international standards" in its allocation of profits between two Amazon entities.[111]

The EC became interested when they noticed Amazon's EU entity had almost zero profit, and therefore minimal corporate tax liability, despite very strong sales.[112] Most of Amazon's EU profits were booked in Luxembourg, but untaxed.[113] More specifically, Amazon created a hybrid arrangement similar to the Scenario 1 illustrated above.[114] The arrangement in question involved Amazon EU Sarl (its main European entity) and a limited liability partnership (LLP) set up in Luxembourg to collect intellectual property royalty payments.[115] Amazon EU would make tax-deductible royalty payments to the Luxembourg LLP.[116] In addition to Amazon EU deducting the royalty payments, the Luxembourg LLP was not taxed on the payments[117] as taxing royalties is illegal in the EU.[118] The result was a D/NI outcome similar to Scenario 1 above. Amazon's main EU entity was left with virtually no taxable income because the majority of its profit was shifted to the Luxembourg LLP.[119]

Amazon, as alleged by the EU commission, allocated too much of its revenue as royalties for intellectual property to the Luxembourg LLP.[120] Furthermore, back in 2003, Luxembourg said it would essentially cap the amount of profits that could be taxable in its jurisdiction.[121] Regulators questioned the "objective basis" for the cap as well as the amount of royalty payments allowed.[122] The Commission posited that "they [the entities in the arrangement] do not seem to be based on any arm's length reasoning."[123] Essentially, the hybrid arrangement merely shifts profits. The commission argues that the situation amounts to an "illicit state subsidy" and the jurisdiction's lost tax revenue must be repaid.[124]

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[111] *Id.*

[112] Tim Worstall, *Following Apple and Starbucks, Amazon Now Faces European Commission Tax Probe*, FORBES (Oct. 7, 2014, 6:50 AM), http://www.forbes.com/sites/timworstall/2014/10/07/following-apple-and-starbucks-amazon-now-faces-european-commission-tax-probe/ [hereinafter *Tax Probe*].

[113] *EU to Investigate Amazon Tax Ruling for State and Breach*, ERNST & YOUNG LLP (Oct. 2014), http://www.ey.com/LU/en/Newsroom/PR-activities/Articles/Article_201410_EU-to-investigate-Amazon-Tax-Ruling-for-state-and-breach [hereinafter *EU to Investigate*].

[114] *Id.*; *see supra* Part II.D(1).

[115] *Id.*

[116] *Id.*

[117] *Id.*

[118] *Tax Probe*, *supra* note 112.

[119] *EU to Investigate*, *supra* note 113.

[120] *Id.*

[121] Barker, *supra* note 109.

[122] *EU to Investigate*, *supra* note 113.

[123] Barker, *supra* note 109.

[124] *Id.*

The investigation remains ongoing as regulators continue to grapple with broader policy issues concerning MNE taxation.[125] Even though Amazon has ceded to international pressure and agreed to stop shifting the majority of its EU profit through Luxembourg, greater questions remain.[126] If Luxembourg is found to be in violation of tax regulations, it is unclear how this will immediately affect Amazon as a whole or other similarly structured hybrids in Europe.[127] Despite the fact that Amazon was "dodging" tax liability, it did so with the approval of the Luxembourg government.[128]

Commentators point out that the EU isn't even focusing on the most important aspect of the Amazon scenario—the underlying tax structures that are making the EU feel as though Luxembourg and Amazon have an unfair advantage.[129] Regulators, according to the preliminary conclusions letter, are more concerned with the tax liability that was supposedly left unpaid. The investigation is more reactionary than proactive in orchestrating changes. This is one of the reasons why the EU may want to develop a EU-wide, standardized set of tax regulations similar to the OECD proposals. They could avoid situations like the Amazon scenario where one country is developing tax agreements with companies that are perfectly acceptable to that country but viewed as illicit by neighboring countries.

III. ANALYSIS

A. Challenges with Entity Classification

The categorization of hybrid mismatch arrangements helps identify the specific types of arrangements that the OECD seeks to minimize to negate DD and D/NI outcomes.[130] However, even with the extensive definitions and scenarios in the discussion drafts, the categories are still broad in terms of the arrangement permutations they encompass.[131] Many issues can stem from the

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[125] Lisa Fleisher & Sam Schechner, *Amazon Changes Tax Practices in Europe amid Investigations*, WALL ST. J. (May 24, 2015), http://www.wsj.com/articles/amazon-changes-tax-practices-in-europe-amid-investigations-1432480170.

[126] *Id*.

[127] Barker, *supra* note 109.

[128] Tim Worstall, *Amazon's Tax Dodging in Luxembourg Might Have Been State Aid Says European Union*, FORBES (Jan. 16, 2015), http://www.forbes.com/sites/timworstall/2015/01/16/amazons-tax-dodging-in-luxembourg-might-have-been-state-aid-says-european-union/.

[129] Barker, *supra* note 109.

[130] DELOITTE LLP, *supra* note 47.

[131] *Tax Policy Bulletin*, *supra* note 6.

OECD's proposed plan for dealing with hybrid entities and arrangements, most of which arise from classification of the entities and transactions.[132]

The treatment of partnerships under tax treaties is one of the challenges with entity classification.[133] Given the differences in tax treatment between corporations and partnerships (e.g. taxation at the entity level for corporations versus taxation of the individual partners for partnerships), many uncertainties can arise when jurisdictions classify entities differently for tax purposes.[134] Pass-through taxation of partnerships adds a level of complexity to the bilateral treaty analysis.[135] While the complexities of the issue are beyond the scope of this Note, many problems arise when inconsistencies in the classification and/or the jurisdiction allow the entity to operate as fiscally transparent (disregarded).[136] Another difficulty affecting the OECD proposal is in the classification and treatment of other hybrid entities.[137] While the OECD has drawn the categories widely enough to encompass many of the most prominent hybrid entities, many more hybrids are unaffected by the rules.[138]

Non-traditional standards can also cause difficulties in classifying entities, such as the U.S.' "check-the-box" (CTB) regime.[139] Such regulations allow certain entities to opt out of the default entity classification and elect to operate under another business form.[140] When CTB extended to foreign entities, regulators were concerned with the possibility of the CTB regime giving rise to more hybrid entities and increased opportunities for mismatched tax treatment of those entities.[141]

Another concern is that the CTB election could influence the foreign classification of the entity.[142] In 1995, when the United States extended CTB to MNEs and foreign entities, regulators feared that foreign corporations would be able to create pass-through tax treatment in the United States by checking the partnership box (as long as the entity was not a *per se* corporation as defined by the Treasury regulations).[143] Since the rise of CTB, the United States used hybrid

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[132] Brauner, *supra* note 20, at 82.

[133] *Id*.

[134] David L. Forst, *The U.S. International Tax Treatment of Partnerships: A Policy-Based Approach*, 14 BERKELEY J. INT'L L. 239 (1996).

[135] *Id*. at 253.

[136] *Id*.

[137] Brauner, *supra* note 20, at 82.

[138] *Tax Policy Bulletin*, *supra* note 6.

[139] Brauner, *supra* note 20, at 82.

[140] IRM 4.61.5.1 (May 1, 2006); *see also* Treas. Reg. § 301.7701.

[141] Kenan Mullis, *Check-the-Box and Hybrids: A Second Look at Elective U.S. Tax Classification for Foreign Entities*, TAXANALYSTS (Nov. 4, 2011), http://www.taxanalysts.com/www/features.nsf/Articles/58D8A3375C8ECCD18525793E0055EB9B; *see also* I.R.S. Notice 95-14, 1995-14 I.R.B. 7 at 3-4.

[142] I.R.S. Notice 95-14, 1995-14 I.R.B. 7 at 4.

[143] Mullis, *supra* note 141.

structures to substantially invest in the UK, often organized around U.S. CTB rules to ensure a D/NI on loans between affiliated entities.[144] Far more complex structures have also been created to capitalize on CTB.[145] Complexity of entity classification poses a significant hurdle to the success of the OECD rules.

B. Challenges with Hybrid Instruments

Currently, hybrid instruments are classified in different, conflicting ways across jurisdictions, and there is no easy solution reconciling the differences.[146] One of a country's most confounding decisions is often the classification of a hybrid instrument as debt or equity.[147] Historically, the debt and equity classification has been an "all or northing" choice.[148] In reality, characterizing modern hybrid instruments is complex.[149] Classification has significant tax liability implications. Arbitrage opportunities for companies who successfully argue that the instruments are equity and threaten tax stability.[150] The classification of hybrid instruments presents significant challenges.

C. Who Is International Tax Competition Actually Harming?

Broad analysis of tax policies across jurisdictions reveals a common trend: countries want to remain competitive in the international market to stimulate international investment and economic growth.[151] Steven Go and Joseph Wu, international tax advisors based in Taiwan, argue that today's tax competition is "simply the product of structural changes in a global economy."[152] They acknowledge all countries are pressured for increased revenue, due in part to the

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[144] *Hybrid Mismatches–UK Proposals for Implementing the BEPS Recommendations*, MCDERMOTT WILL & EMERY, (Dec. 17, 2014), http://www.mwe.com/Hybrid-Mismatches-UK-Proposals-for-Implementing-the-BEPS-Recommendations-12-16-2014/.

[145] *See* Robert W. Wood, *Ireland Corks Double Irish Tax Deal, Closing Time for Apple, Google, Twitter, Facebook*, FORBES (Oct. 14, 2014, 2:37 AM), http://www.forbes.com/sites/robertwood/2014/10/14/ireland-corks-double-irish-tax-deal-closing-time-for-apple-google-twitter-facebook/.

[146] Brauner, *supra* note 20, at 82.

[147] Lee A. Sheppard, *Defending Cross-Border Debt-Equity Cases*, TAX ANALYSTS (Jan. 23, 2014), http://www.taxanalysts.com/www/features.nsf/Articles/F9EE0B6A5E577A7085257C6A00513DCE?OpenDocument.

[148] Brauner, *supra* note 20, at 82.

[149] *Id.*

[150] *Id.* (noting the different financial instruments and issues relating to their classification, which is beyond the scope of this Note).

[151] *Tax Policy Bulletin*, *supra* note 6.

[152] Go & Wu, *supra* note 27.

rise of developing countries increasing their wealth and global positioning through lower taxes.[153] If the OECD proposals are taken too far, they could stifle this "economic liberalization" of countries and jurisdictions.[154] The challenge for OECD in drafting its rule sets is finding the appropriate balance between free competition and regulation. Go and Wu believe the OECD can help countries achieve "beneficial tax competition."[155]

As previously mentioned, the OECD believes global tax competition to be harmful on the basis that it reduces global welfare.[156] Go and Wu assert that a government, as the leader of a sovereign nation, should serve its own people before all other stakeholders in the international economy.[157] The following example illustrates this principle. Government A decides to cut corporate tax rates for Country A. Companies move to Country A to take advantage of the lower tax rates. However, Countries B and C are upset they are losing tax revenue due to the migration of companies to Country A. Should Country A be blamed for the way its decision negatively affected Countries B and C? While this seems obvious, it is not so obvious in the context of the international marketplace when people talk about "negative fiscal externalities," such as the effects on Countries B and C in the above example.[158]

Although falling tax rates have characterized the recent international tax landscape, this is not the only way tax competition is affected.[159] Many countries employ defensive tax rules to prevent corporations from taking advantage of the lower tax rates offered by countries competing for the tax revenue, but the complexity of these rules could be a burden to international tax reform in the long term.[160] One key objective of the OECD is developing rules that "support the efficient operation of global markets."[161] By recognizing that not all tax competition is harmful and furthering rules that help "beneficial tax competition," as discussed by Go and Wu, the OECD can help eliminate the harmful effects of BEPS while actually improving tax efficiency.

Many countries, including the UK, Germany, Sweden, Denmark, Mexico, France, Australia, and the Netherlands, have adopted some form of the draft rules.[162] According to tax experts, one of the biggest challenges for the

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153 *Id*.
154 *Id*.
155 *Id.*
156 *Action Plan*, *supra* note 1, at 15.
157 Go & Wu, *supra* note 27.
158 *Id*.
159 *Id*.
160 *Id*.
161 Pascal Saint-Amans & Raffaele Russo, *What the BEPS Are We Talking About?*, ORG. FOR ECON. COOPERATION AND DEV. (2013), http://www.oecd.org/forum/what-the-beps-are-we-talking-about.htm.
162 *Tax Policy Bulletin*, *supra* note 6, at 7.

OECD plan going forward is whether the individual countries' adoption of the rules actually creates some uniformity and congruence.[163] The experts give the example of the UK, where many of the OECD draft rules have been adopted but older, incompatible rules had to either be altered or eliminated.[164] Included in the elimination was the "purpose test" that dictates the UK's anti-arbitrage statutes apply only when the purpose of the hybrid arrangement is to obtain a UK tax advantage.[165] In contrast the OECD rules apply in blanket fashion and include no such test.[166] Countries' adoption of the rules at the domestic level is necessary to achieve meaningful change.[167]

IV. IMPLICATIONS

A. Early Implementation: The United Kingdom

Proponents of immediate adoption argue that if the new rules are integrated properly, tax jurisdictions will realize benefits immediately.[168] The OECD argues the drafts provide enough detail to allow countries to implement the new rules.[169] While Action 2 might be more straightforward to develop domestic rules, the interaction of the various decision rules still provides some uncertainty for governments and MNEs.[170] Closer examination of the tax law regime in the UK yields valuable insight into potential immediate effects of implementation.

The UK government took the lead on implementation when it released a consultation document at the end of 2014.[171] In the document, the government addressed several BEPS issues, voiced its commitment to the OECD proposals, and outlined specific regulatory steps for the UK to take in connection with Action Item 2.[172] The government proposed completely removing the old anti-

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[163] *Id*.

[164] *Id.*

[165] *Id*.

[166] *UK Issues Consultation Document on Implementing OECD Proposals on Hybrid Mismatches*, ERNST & YOUNG LLP (Dec. 9, 2014), http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--UK-issues-consultation-document-on-implementing-OECD-proposals-on-hybrid-mismatches [hereinafter *UK issues*].

[167] *Tax Policy Bulletin*, *supra* note 6.

[168] *Weekly Tax Matters,* KPMG LLP (UK) (Oct. 10, 2014), http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Tax/weekly-tax-matters-101014.pdf.

[169] *Id*. (noting that the UK committed to leading the way on this implementation).

[170] *Id*.

[171] *Government Takes Further Step to Clamp down on Aggressive Tax Planning*, HM TREASURY (Oct. 5, 2014), https://www.gov.uk/government/news/government-takes-further-step-to-clamp-down-on-aggressive-tax-planning.

[172] *Id*.

arbitrage regulations and replacing them with the new OECD-inspired rules.[173] Tax planners believe that the new rules will actually cover a wider range of scenarios than the UK's old rules.[174]

Under the old anti-arbitrage scheme, the UK had something similar to a safe harbor provision. Her Majesty's Revenue & Customs (HMRC) would screen arrangements to ensure that they were in compliance and did not constitute "an arrangement for UK tax avoidance" (application of the purpose test).[175] Now, with the purpose test eliminated, many of these previously approved arrangements may no longer be legal under the new rules.[176] Thus, the new rules could give rise to more tax controversy in the short term.

The proposed rules also change the tax environment for many dual-resident companies.[177] The proposed UK rule is almost identical to the OECD rule governing dual-resident companies: no UK deductions are allowed unless matched by income included in both jurisdictions.[178] The only exception to this rule is when the UK and the second jurisdiction have agreed who will allow the deduction.[179] This could potentially cause the dual-resident company to lose the deduction in both jurisdictions.[180] The UK previously had additional exemptions in place, but the wider scope of the OECD rule will apply to all dual-resident companies.[181] The use of hybrids has historically been a pivotal component of U.S. investment in UK companies,[182] and much of this tax planning could be disrupted with the proposed UK rule changes.[183]

Some experts argue that the progress in the UK is more harmful than helpful.[184] Furthermore, the recent developments reveal one of the glaring problems with the OECD proposals: the unintended consequences of unilateral action.[185] The Action Plan is surprisingly comprehensive and the priority rules of Action Item 2 serve as a solid blueprint for both domestic laws and coordination efforts between countries. However, many tax policy experts argue that in reality

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[173] *See UK Issues, supra* note 166 (noting that the regulations include topics such as income brought into the country under a controlled foreign company (CFC), the treatment of repurchases and stock loans, and some variations on imported mismatches).

[174] *Id.*

[175] *Id.*

[176] *Id*.

[177] *Id.*

[178] *UK issues, supra* note 166.

[179] *Id*.

[180] *Id*.

[181] *Id*.

[182] MCDERMOTT WILL & EMERY*, supra* note 144.

[183] *Id.*

[184] *See* James J. Tobin, *Lots of BEPS Output – What Outcome?*, BLOOMBERG BNA (Dec. 22, 2014), http://www.bna.com/lots-beps-output-n17179921277.

[185] *Id.*

the Action Plan only works if countries collaborate.[186] As countries such as the UK continue to implement BEPS measures without global coordination, inconsistencies across tax jurisdictions could multiply rather than disappear.[187] For example, if jurisdictions begin unilaterally disallowing certain deductions without guidance or coordination from other countries (as Spain began doing),[188] two different jurisdictions could end up trying to tax the same income. Not only could double taxation have a negative impact on tax revenue, it could also hurt the jurisdiction's competitiveness globally.

The recent developments in the UK provide both promise and concern for those jurisdictions considering adoption of the OECD proposals. For some jurisdictions such as the UK, the new set of regulations will be much broader than the old rules and will overlap. They can cause old regulations to either be abandoned or modified. In other cases, the rules may address issues that had not previously been noted. Regardless, some level of coordination effort among countries is essential for continued progress. Furthermore, the OECD will have to continue development of certain areas of its proposals as more counties begin implementation and encounter obstacles in the process.

B. Implications for the United States

The United States has long sought to minimize erosion of its taxable base by MNEs.[189] Taxing income globally has posed some challenges for the United States as more companies opt to employ hybrid structures to avoid tax on repatriated income. As other jurisdictions such as the UK begin the implementation phase of the BEPS Action Plan, tax experts in the United States are concerned about the proposals in Action Item 2 because they could negatively affect the U.S. tax regime.[190] While there are valuable takeaways from the Action Plan, including the importance of collaboration, the OECD proposals could lead to an erosion of the U.S. tax base, put a strain on some of the underpinnings of the global taxation system, and catalyze issues relating to intergovernmental relations and authority. Both lawmakers and MNEs alike recognize the need for reform

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[186] *Id.*

[187] *Id.*

[188] *Global Tax Alert: Spanish Central Tax Court Disallows Tax Deductibility of Delay Interest*, ERNST & YOUNG LLP (July 7, 2015), http://www.ey.com/Publication/vwLUAssets/Spanish_Central_Tax_Court_disallows_tax_deductibility_of_delay_interest/$FILE/2015G_CM5582_Spanish%20Central%20Tax%20Court%20disallows%20tax%20deductibility%20of%20delay%20interest.pdf.

[189] David Ernick, *Will a Sponge Tax Soak up BEPS Concerns*, BLOOMBERG BNA (Jan. 5, 2015), http://www.bna.com/sponge-tax-soak-n17179921836/.

[190] *See* Tobin, *supra* note 184.

globally, but the constraints the OECD proposals place on tax policy render it a less than ideal option for the United States.[191]

The proposals may harm the U.S. tax system by shifting the additional tax revenue out of the United States[192] Due to the international crack-down on BEPS, foreign jurisdictions are incentivized to collect on tax that would typically travel back to the United States. The result: U.S. companies will pay a higher level of foreign tax.[193] Take Apple, for example, which manufactures many of its components in China.[194] A large portion of corporate taxes Apple pays to the United States would be paid to China under the proposed OECD rules, according to economist Joseph Stigiltz.[195] Not only will fixing the hybrid "problem" cause U.S. companies to pay more foreign tax, but increased tax controversy and greater uncertainty around the global taxation scheme could result.[196]

The OECD proposals could also affect the IRS foreign tax credit and subsequently the underpinnings of the U.S. global taxation system.[197] Traditionally, the United States has subsidized some of the foreign taxes imposed on U.S. MNEs.[198] The foreign tax credit helps the entity recoup some of what was paid to foreign tax jurisdictions.[199] If other countries continue to follow the OECD's lead, MNEs will be left with substantially larger tax bills and claim the foreign tax credit with greater frequency.[200] Consequently, U.S. tax revenue could be eroded by a dramatic increase in foreign tax credit claims.[201] Therefore, the Treasury must determine if the foreign tax credit should still remain a subsidy.

Conflicts related to governmental authority have also come to light in U.S. dealings with the OECD.[202] While the Treasury Department has largely been

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[191] Press Release, U.S. Senate Committee on Fin., Hatch, Ryan Call on Treasury to Engage Congress on OECD International Tax Project, (June 9, 2015) http://www.finance.senate.gov/newsroom/chairman/release/?id=ff0b1d06-c227-44be-8d5a-5f998771188b.

[192] Ernick, *supra* note 189.

[193] *Id*.

[194] *Supplier Responsibility,* APPLE INC., http://www.apple.com/supplier-responsibility/our-suppliers/ (last visited Sept. 25, 2015).

[195] Ben Walsh, *The International Tax System Is 'Repulsive And Inequitable.' Here's a Way to Fix It,* HUFFINGTON POST (Aug. 20, 2015), http://www.huffingtonpost.com/entry/multinational-corporations-taxes_55d4baede4b055a6dab265d9.

[196] Aparna Mathur, *The U.S. Is Right to Worry about the OECD's BEPS Project*, FORBES (June 22, 2015), http://www.forbes.com/sites/aparnamathur/2015/06/22/the-u-s-is-right-to-worry-about-the-oecds-beps-project/print/.

[197] Ernick, *supra* note 189.

[198] *Id*.

[199] *Id*.

[200] *Id*.

[201] *Id*.

[202] Press Release, U.S. Senate Committee on Fin., In Speech, Hatch Outlines Concerns with OECD International Tax Project (July 16, 2015)

the liaison between the U.S. government and the OECD, members of Congress are quick to remind the Treasury that Congress has the power to write tax laws for the United States (including laws governing cross-border transactions and multinational companies).[203] In an impassioned address on the Senate floor, Finance Committee Chairman Orrin Hatch claimed the Treasury is negotiating the terms of these Action Items without the input of Congress, and oftentimes the Treasury commits the United States to making changes to its tax system without any involvement from lawmakers or tax legislation committees.[204] He contended the U.S. tax base should not be "up for grabs in an international free-for-all."[205] In other words, certain commitments the Treasury has already made to the OECD are undermining the U.S. global taxation regime and its countless treaties. He concluded that parts of the BEPS project could damage U.S. efforts to comprehensive tax reform.

Ultimately, countries are going to adopt the OECD proposals that serve their interests.[206] As more countries continue to follow the UK's lead in implementation, competition for tax revenue will only increase.[207] The OECD BEPS project will affect the United States whether or not it chooses to adopt the suggested provisions.[208] Therefore, the United States needs to ensure that it protects the interests of U.S. companies and the government.[209] In terms of tax policy, the United States cannot support a plan that potentially diverts tax revenue away from itself, increases tax controversy, and undermines the U.S. tax system. However, there are very valuable insights, goals, and strategies to be gained from the ever-evolving BEPS project.[210] The United States will need to consider the policy issues associated with supporting the OECD BEPS project and must balance those concerns against the need for reform and a new set of best practices in the international tax arena.

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http://www.finance.senate.gov/newsroom/chairman/release (follow links to July 16 release).

[203] *Id.*

[204] *Id.*

[205] *Id*.

[206] Tobin, *supra* note 184.

[207] Mathur, *supra* note 196.

[208] Jeremy Scott, *Can the United States Kill BEPS?*, FORBES (June 16, 2015), http://www.forbes.com/sites/taxanalysts/2015/06/16/can-the-united-states-kill-beps.

[209] Tobin, *supra* note 184; *see also* Ernick, *supra* note 189 ("And, more importantly, certain of the BEPS 'solutions' espoused so far would disproportionately impact U.S. MNEs and have the effect of a direct federal transfer of tax revenue to foreign governments – sponge taxes which 'divert to [foreign governments] tax money that would otherwise find its way to the federal fisc' should be avoided.").

[210] Tobin, *supra* note 184.

IV. CONCLUSION

Regardless of a jurisdiction's policy position on taxation, tax competition, and a new international tax framework, it is almost universally agreed that there are some problems and inconsistencies in the current international tax regime.[211] Countries that adopt the OECD proposals and begin to legislate will inevitably impact hybrid financing arrangements and MNEs that utilize offshore profit shifting structures.[212] While the OECD should be commended for putting forth a plan for addressing many of the perceived problem areas of international taxation, there are many more uncertainties that need to be worked out.[213] There could be significant increases in compliance and transaction costs, given that more disclosure and documentation will be required.[214] Countries like the UK that are spearheading adoption, will provide valuable data that other countries can use to determine how to begin implementation.

It is clear that coordinated efforts are crucial for progress. Through use of the draft rules and the treaty provisions, the OECD remains hopeful that jurisdictions will be able to work together to minimize the detrimental effects of hybrid mismatch arrangements debated in this Note. At the same time, the international tax regime is a competition-based system. Jurisdictions will do what is in their best interest. The OECD will have to figure out how to strike a balance between combatting double non-taxation and prohibiting arrangements that promote economic activity. At the end of the day, jurisdictions want to solidify their tax base and prevent further erosion of tax revenues. While it is unclear whether these proposals will bring any benefit to the United States, all eyes will be on the OECD's proposals as reform takes shape.

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211 Ernick*, supra* note 189.

212 *Double Non-Taxation and OECD'S BEPS Action Plan,* ZETLAND FIDUCIARY GROUP LTD. (Nov. 2013), http://www.zetland.biz/newsletter/1311newsletter/NonTax.htm.

213 *See* Ernick, *supra* note 189.

214 *OECD Releases Report*, *supra* note 42.