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Mr. Pascal Saint-Amans
Director
OECD/Centre for Tax Policy and Administration (CTPA)

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

Subject: BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws) (Public Discussion Draft)

Dear Mr. Saint-Amans and Mr. Pross:

We are pleased to submit comments on behalf of Deloitte Tax LLP, a U.S. member firm of Deloitte Touche Tohmatsu Limited ("DTTL")[1] regarding the Public Discussion Draft, *"BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)"* (the "Discussion Draft"). We appreciate this opportunity to share our views on the Discussion Draft and hope you find our comments useful in your work on BEPS Action 2.

I. Introduction and Overview

We appreciate the concerns of the OECD regarding the deduction / no inclusion ("D/NI") and double deduction ("DD") outcomes that result from dissimilarities among countries' tax laws addressing financial instruments and business entities. It is important to remember, however, that these laws affect the flow of capital across borders and in worldwide markets. These larger economic matters are of great importance to the OECD, its members, and their taxpayers. Any proposals advocated by the OECD should take into account their broader economic impact, and should be designed with caution.

For example, the Discussion Draft recommends changing laws so that the tax jurisdiction of a payer denies deductions in certain circumstances where receipt of the payment is not taxed as ordinary income. The benefit of a payer's deduction, however, is generally conferred in order not to over-tax a business enterprise funded with what the payer jurisdiction views as debt; without the deduction, the rate of

[1] Please see www.deloitte.com/about for a detailed description of DTTL and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

return derived from that business enterprise will be reduced, making investment in it less attractive, and decreasing the payer jurisdiction's ability to attract capital investment that fuels economic growth.

In light of these effects, a sufficiently broad lens must be used in evaluating the costs and benefits of changing the taxation of cross-border financing. The circumstances in which tax is increased must be targeted so as to minimize interference with capital investment. One example of balancing such competing interests can be found in the enactment by the United States of the so-called portfolio interest exception, the result of a decision to forego U.S. jurisdiction to tax portfolio interest in order to enhance U.S. access to global capital markets.[2] We believe that the Discussion Draft does not achieve the correct balance. The proposals as drafted are likely to disrupt capital markets and may lead to a higher cost of capital.

In addition, the causes of mismatched cross-border tax outcomes are far broader than hybrid mismatch arrangements. Uniformity among national tax systems does not exist, and not simply because of differences in rules for classifying financial instruments and business entities. We fail to see why cross-border financial transactions should be viewed as the one arena in which the laws of one country must, uniquely, depend on those of another; such dependence would inevitably take the complexity level of tax compliance and planning to uncharted heights.[3] We submit that many of the issues discussed in the Discussion Draft are better addressed through other, more narrowly tailored approaches, such as comprehensive controlled foreign company (CFC) rules, coordinated thin capitalization limitations, and income tax treaties. These alternative avenues will satisfy the policy concerns articulated in the Discussion Draft without inflicting the type of collateral damage discussed below. In addition, addressing these issues through income tax treaties will allow conflicting tax jurisdiction claims to be mediated through the mutual agreement process.

Prompted by the foregoing considerations, our specific recommendations for changes to the Discussion Draft proposals include the following:

– Make any hybrid mismatch neutralization rules applicable only to controlled party transactions.

– Treat income of a payee taxed by *the source country* (e.g., via withholding tax) no worse than income of a payee taxed by the payee's residence country.

– Treat income of a payee that will be taxed *in the hands of an owner of the payee* (either currently[4] or upon repatriation) no worse than income taxed in the hands of the payee.

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[2] *See* section 127 of the Tax Reform Act of 1984, Pub. L. No. 98-369 (July 18, 1984).

[3] It should be noted that since 1986 the United States has attempted to address DD and D/NI outcomes in a far more narrow set of circumstances in the "dual consolidated loss" provisions, and the complexity associated with those provisions has caused many to suggest that they be repealed. See, for example, section "__92" of then-Finance Committee Chairman Baucus's discussion draft of international tax reform, described in Joint Comm. on Taxation, *Technical Explanation of the Senate Comm. on Finance Chairman's Staff Discussion Draft of Provisions to Reform International Business Taxation* (JCX-15-13), November 19, 2013, at 82.

[4] For example, where the United States is the owner's residence country, it taxes the owner via "subpart F."

- Drop the imported mismatch proposal.

- Address transition issues that would be created by adoption of any proposed hybrid mismatch neutralization rules.

II. Limit the Scope of any Proposed Law Changes to Intra-Controlled Group Transactions

We recommend that the scope of any OECD hybrid mismatch neutralization proposal be limited *solely* to transactions between members of the same controlled group, where control is defined by reference to greater-than-50-percent direct or indirect ownership by a single company (rather than the 50-or-more-percent commonality-of-ownership threshold that the Discussion Draft uses for its definition of "control group").

The laws proposed by the Discussion Draft, if implemented, would deny deductions, or cause ordinary income inclusions, in financing transactions including (1) those within controlled groups, (2) those between persons with as little as 10-percent common ownership, and (3) those between persons with even less common ownership or no common ownership, if a transaction is a "structured transaction" or if the participants meet an "acting in concert" definition. We think that such a scope is ill-advised for several reasons. First, in order to implement such a system, the investor and the issuer must be identified and their tax treatments under the specified transactions must be known to each other simply in order to determine if the proposed rules apply. In uncontrolled party transactions, this information will often be difficult or impossible to obtain for both tax administrators and taxpayers, absent a new and complex information reporting system. Second, it is imperative that the class of circumstances affected by the Discussion Draft's proposed substantive rules be separated by a bold and objective demarcation line from the class of circumstances unaffected by such rules. Yet reference to admittedly fluid, open-ended concepts like whether transactions are "structured," and whether parties are acting in concert, injects inherent uncertainty into the question of scope. The *in terrorem* effect of uncertainty regarding whether these highly complex proposed rules do or do not apply in any particular case would do little if any good, and much harm, in terms of chilling cross-border economic activity, as well as voluntary compliance with the law.

For a party to a transaction to apply the rules as proposed in the Discussion Draft, the party must know how the transaction is treated under the laws of another country, even in the hands of an uncontrolled person (or an investor in the uncontrolled person). Even with perfect access to information, the very treatment of the uncontrolled person may well be inherently uncertain. For example, determining whether a particular financing transaction is debt or equity under a particular country's tax laws often is not straightforward. In practice, characterizing a financial instrument under the laws of even one jurisdiction (for example, an issuer characterizing an instrument under the laws of its residence country) may be a challenging endeavor;[5] to be forced to make the determination from the perspective of

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[5] For example, the United States was unable to issue final regulations defining when a particular investment is treated as debt and when it is treated as equity; instead, the United States relies on a "facts-and-circumstances" analysis to determine the appropriate treatment. Indeed, two financial instruments with identical terms may be considered debt in one case and equity in the other from a U.S. perspective, depending on various factors such as the intent of the parties and the credit rating of the issuer. *See, e.g., Estate of Mixon v. United States,* 464 F.2d 394 (5th Cir. 1972).

uncontrolled counterparties (for example, an issuer characterizing the instrument under the laws of every independent holder's residence country), under the laws of jurisdictions that do not apply to the person making the determination, would be unreasonably difficult. There will surely be legitimate disputes between independent parties (putting aside disputes between one or both of the parties and *the tax authorities* of their respective residence countries) as to whether a particular transaction even *amounts* to a hybrid transaction. In the event one taxpayer believed a transaction to be a hybrid and it was later determined (say, after examination by a tax authority) *not* to be a hybrid, any reasonable hybrid mismatch rule would need to provide an avenue to reverse the impact of their mistaken application.

Under these circumstances, a low threshold for "relatedness," such as the proposed 10-percent threshold in the Discussion Draft, would create a huge administrative burden for taxpayers and administrators. Furthermore, the risk of tax abuse at such low affiliation levels is minimal. The compliance burden in the case of taxpayers with such low affiliation levels would achieve only an incommensurate tax policy benefit. The proposed hybrid mismatch neutralization rules cover a broad spectrum of financial arrangements, many of which have no tax planning motivation. For these reasons we recommend that any rules be limited to controlled party transactions.

Not all tax planning, including planning with hybrids, is abusive tax planning. Entities used as vehicles for unrelated party investors are often treated as reverse hybrids for purposes of some of the investors. Such entities may be used to pool capital from unrelated parties and make lower tier investments. Such entities perform the important function of aggregating capital across entities from various jurisdictions, as well as from taxable and tax-exempt entities. The entity may, in turn, utilize debt rather than equity in order to fund a lower tier entity in a tax efficient manner.

In this context, the fact that the entity is a reverse hybrid from the perspective of some of its investors should not be viewed as abusive tax planning. While the entity may result in different income recognition among the investors, this is a difference in timing only. Furthermore, the entity can promote efficiency and flexibility in aggregating capital from various sources. Absent the use of such hybrid entities, separate entities would have to be deployed by separate investors to achieve each jurisdiction's desired investment structure, resulting in additional administrative costs and unnecessary complexity. There would be no real tax benefit derived from imposing the proposed reverse hybrid mismatch rules in this context because the same treatment could be achieved by each investor investing through a separate entity treated as fiscally nontransparent in all jurisdictions with the same tax effect as that applicable to the hybrid entity.

It should be observed that many transactions that are "hybrids" for tax purposes, such as unrelated party stock lending and repurchase transactions, are executed every day for non-tax reasons. These transactions play an important role in expanding the liquidity of the equity markets in the form of collateralized borrowings. Due to the volume of these transactions, they should not be subjected to a separate tax reporting regime necessary to implement the Discussion Draft's hybrid mismatch neutralization rules.[6] In addition, hybrid transactions are used by financial services entities in order to

[6] According to the US Repo Fact Sheet 2012 published by the Securities Industry and Financial Markets Association (SIFMA), securities repurchase transactions total $5 trillion in daily turnover. See SIFMA, Repo Market Fact Sheet 2012, *available at* http://www.sifma.org/research/item.aspx?id=8589939674.

meet regulatory capital requirements. The use of the hybrid instruments for regulatory capital purposes is applicable to both controlled and non-controlled transactions. Financial services groups utilize hybrid instruments to finance lower tier subsidiaries in order to satisfy regulatory capital requirements applicable to those subsidiaries. For these reasons, use of hybrid instruments to meet regulatory capital needs should be excluded from any hybrid mismatch neutralization rules.

III. The Rules Proposed in the Discussion Draft Define Income Inclusions Too Narrowly

The Discussion Draft appears to reflect an overly narrow concept of the circumstances under which income should be treated as "included" for purposes of the Discussion Draft's recommendations. Source-country taxation and third-country taxation of a payee's income represent taxation of that income, even if the payee bears no residence-country taxation.

"Deferral" systems

Hybrid mismatch neutralization should not be merely a two-country exercise. For example, whether or not the payment in Figure 1 of the Discussion Draft from B Co to A Co creates a D/NI or DD outcome is not solely a function of the tax laws of Countries A and B. A Co may be the subsidiary of a C Co in whose hands A Co's income is or will be taxed. In our view, any proposal along the lines of those in the Discussion Draft would impose a double taxation outcome unless it treated taxation of income of a payee in the hands of an investor in a third country, whether currently or upon distribution, the same as the taxation of income in the hands of the payee itself.[7]

An obvious case where deductions should not be denied would be one where C Co is subject to CFC rules imposing current tax on C Co with respect to A Co's receipt from B Co. The Discussion Draft, however, also acknowledges that differences in the rules for timing the inclusion of income do not rise to the level of "hybridity" for purposes of the proposed rules. One example not discussed in the Discussion Draft is the difference between immediate taxation in the payer or payee's jurisdiction, and deferred taxation in an investor jurisdiction with a "deferral" rather than a "territorial" system for generally taxing the income of a resident's CFCs. Such a system may prevent deferral only with respect to passive income, and may not include within the scope of its anti-deferral rules interest paid by a CFC that is allocated to its active income. Yet even if the operating company's payment is not subject to immediate income inclusion at the level of the payee company's investor under the latter's CFC rules, and also is deductible by the payer, there would still be no D/NI or DD result. If CFC rules do not subject the receipts of the payee to *immediate* taxation, such receipts *will* be subject to tax upon repatriation to its investor, and the evidence shows that such receipts often *are* ultimately repatriated. Thus, if a multinational enterprise has a common parent that is taxed on repatriations of foreign subsidiary earnings, such taxation should be taken into account in deciding whether a D/NI or DD outcome will occur.

Withholding taxes

[7] Paragraph 220 of the Discussion Draft appears to call off the proposed rule for reverse hybrids in the case of anti-deferral or other rules that tax income accrued through tax exempt offshore investment structures on a current basis, but we could find no similar exception from the proposed rules for hybrid financial instruments or entities.

Even where the laws of two countries create the opportunity for a hybrid mismatch, narrowly defined by comparing the *net-basis* taxation of the payer with the *net-basis* taxation of the payee or its investor, the *gross-basis* tax imposed by the source country can eliminate any D/NI or DD outcome. The Discussion Draft proposals are overbroad to the extent that they do not take such source-country taxation of the payee's income into account when defining a hybrid mismatch.[8] If the proposal does not take such source-country gross-basis tax into account, double taxation outcomes would be created. The income of the payee *is* subject to tax when gross-basis tax is imposed; gross-basis taxes are the liability of the payee and compensate for the source country's net-basis tax foregone by reason of the deduction. No further taxation of the payee is necessary to prevent a D/NI or DD outcome.

For the Discussion Draft to propose the denial of deductions where the payer's country or a third country taxes the payee's income clearly would be inconsistent with the objective of BEPS Action 2. Action 2 of the BEPS Action Plan includes "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)." In the cases described above, an interest deduction might be denied by the terms of the Discussion Draft, despite the fact that the interest income *is* includible in income, either via CFC rules that do or will tax the payee's income or via gross-basis taxation by the source country. Furthermore, the Discussion Draft's design principles for hybrid mismatch rules specifically state that such rules should "avoid double taxation through rule co-ordination." Nevertheless, the situations described above would not yield DD or D/NI outcomes absent application of the rules proposed in the Discussion Draft. The Discussion Draft also states that "the hybrid mismatch rule limiting D/NI outcomes should not address differences in the timing of payments and receipts under the laws of different jurisdictions." A deferral regime gives rise to a type of timing difference, and a payee's receipts should not be treated as part of an imported mismatch arrangement simply because the payee is not subject to immediate tax on such receipts under the investor jurisdiction's CFC rules.

IV. Drop the Imported Mismatch Proposal

The imported mismatches portion of the Discussion Draft focuses on back-to-back conduit financing arrangements and situations in which treaties have inadequate rules to limit benefits available to transparent entities. However, the definition of imported mismatches given by the Discussion Draft extends far beyond the back-to-back conduit financing arrangements and treaty abuses the rule was designed to target. Multinational enterprises generate and move capital internally through many different financing transactions, the linkage of which is often difficult, if not impossible. Most multinationals utilize treasury centers to accumulate and deploy cash among related parties. Excess cash is routinely swept from entities in the form of loans or capital contributions and loaned to other affiliates. Requiring multinationals to trace the flow of funds throughout their organizations to determine if they run afoul of the proposed imported mismatch rules would create administrative burdens far exceeding their benefits. Given the disparity between the application of the proposed imported mismatch rules and the objectives they address, we recommend that the imported mismatch rules proposed by the Discussion Draft be eliminated.

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[8] *Cf.* section 163(j) of the U.S. Internal Revenue Code of 1986, which calls off non-deductibility of interest in the payer country when the payee is subject to gross-basis taxation by the payer's country.

V. Transition Rules

The proposed hybrid mismatch neutralization rules represent a broad shift in individual countries' internal laws to harmonize varying tax laws across many jurisdictions with respect to hybrid entities and instruments. Multinational enterprises that are currently complying with the tax laws of various jurisdictions may find themselves subject to drastically different tax rules due to the enactment of such proposals. As such, these proposals should clarify that restructuring to bring arrangements out of the scope of these rules will not be subject to anti-abuse provisions (e.g., GAARs or other general or specific rules) of the countries in which they are doing business prior to enactment.

Moreover, consideration should be given to the fact that different countries will adopt hybrid mismatch neutralization rules at different times over the life of an instrument or structure, and such changes will affect the ordering or linking principles that apply under each country's law. The fact that the proposals call for each jurisdiction's laws to operate by reference to other jurisdiction's laws, yet do not contemplate direct coordination among jurisdictions' legislative processes, will raise novel transitional issues.

For example, assume that B Co issues a hybrid financial instrument to A Co. As of the date of issuance, Country A has adopted the Discussion Draft's proposals but Country B has not. Therefore, B Co deducts payments on the instrument and A Co includes the payments as ordinary income. Later, Country B also adopts the Discussion Draft's proposals. Should the treatment of the two parties to the instrument change, so that Country B now denies B Co the deduction and Country A allows A Co an exemption?[9]

The OECD should devote effort to resolving these issues. In order to prevent excessive uncertainty, the rule to be applied in these cases generally may need to be consistent with the rule that applied as of the time of the issuance of the instrument or establishment of the structure.

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In summary, given the information required to determine whether a hybrid mismatch arrangement exists, the uncertainty of the law regarding debt/equity determination, and the difficulty in linking together various financing transactions, situations in which a hybrid entity or instrument automatically merits a denial of deduction or income recognition should be limited to those within controlled groups, and should take into account the current or eventual tax liabilities of all members of such a group for the income of members of the group. In the case of transactions outside such groups, there are less invasive ways of addressing the policy concerns addressed by BEPS Action 2, including coordinated thin capitalization rules and consistent CFC rules. A coordinated effort to address tax outcomes across

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[9] Transition issues like those raised by the above fact pattern are similar to the issues that can arise upon transfers of interests in entities or instruments between (a) investors that are resident in countries that *have* enacted the Discussion Draft's recommended hybrid mismatch neutralization laws, on the one hand, and (b) investors resident in countries that have *not* enacted such laws, on the other.

jurisdictions using alternatives to the proposed hybrid mismatch neutralization rules will help minimize the significant adverse economic consequences that could result from such rules.

We appreciate your consideration of our comments.

Sincerely,

T. Timothy Tuerff	Gretchen Sierra	Harrison Cohen
Partner	Principal	Director