May 1, 2014

Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Attn. Achim Pross
Head, International Co-operation and Tax Administration Division
2, Rue André Pascal
75775 Paris, France

Re: Comments on OECD Discussion Draft on Hybrid Mismatch Arrangements (Domestic Law Recommendations)

Dear Mr. Pross:

The National Foreign Trade Council (the "NFTC") is pleased to provide written comments on the Discussion Draft on Hybrid Mismatch Arrangements (Domestic Law Recommendations), published March 19, 2014.

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project.

This letter is divided into two parts. The first part provides general comments and observations regarding the main elements of the Discussion Draft. Our general comments highlight three main points. First, the consideration of the Recommended Rules should be deferred until their interaction with other parts of the project, in particular the action items on interest deductibility and CFC rules, can be considered. Second, the policy basis for the Recommended Rules, in particular the implicit division of taxing jurisdiction, should be more fully articulated so that the advisability and content of the rules can be better evaluated. Third, the Recommended Rules should be modified to ensure that they do not result in double taxation. The second part of this letter responds to specific issues identified by the Discussion Draft.

General Comments on Discussion Draft

Consideration of the Recommended Rules Should Be Deferred

The Discussion Draft introduces a complex set of interrelated rules, with primary and secondary linking rules that apply in different ways to different categories of transactions. Because the operation of these rules will depend on an ongoing evaluation of the tax consequences of a transaction or instrument in one or more other countries, they will necessarily be difficult to administer and difficult to comply with.

In general, therefore, decisions regarding the scope and implementation of the rules should be biased in favor of limiting their scope and deferring their implementation. Other BEPS action items will provide recommendations regarding CFC rules and interest deductibility. Depending on the nature of these recommendations, countries may find the issues presented by hybrid mismatch arrangements to be greatly reduced because of the taxation of such arrangements by the investor jurisdiction under CFC rules or the limitations on the deductibility of interest expense in the source jurisdiction. Accordingly, we recommend that any action on the Discussion Draft be deferred until work on the CFC and interest deductibility action items moves forward, and that the timing of the three action items be synchronized.

In addition, the Discussion Draft rightly acknowledges that the compliance burdens related to these rules depend on the extent to which the rules are adopted in a coordinated and relatively uniform manner. *See* paras. 44-45. Further, the rules may produce undesirable domestic tax or economic policy results if applied by only a handful of countries. The OECD has repeatedly extolled the virtues of coordinated action as opposed to single-jurisdiction measures; indeed, this is the primary justification for the BEPS project. Consideration therefore should be given to a mechanism whereby the implementation of any jurisdiction's rules based on the recommendations is deferred until a critical mass of countries has modified their domestic laws, or until the passage of a significant period of time. At that point the compatibility and practicality of these measures can be reevaluated on a more empirical rather than theoretical basis. In addition, at that point countries can ensure that the measures would be adopted in a manner that results in fair or appropriate allocations of taxing jurisdiction and revenue, and that the measures do not have a disproportionately negative impact on the cost of investment in any participating jurisdiction.

The Recommended Rules Have an Unclear Policy Basis, Making Them Difficult to Evaluate

The Discussion Draft proposes significant changes to the domestic tax law of participating countries. The Discussion Draft, however, does not articulate a clear policy basis for these proposed changes. It is important to articulate a policy basis for the proposals for two reasons. First, it may be difficult for policymakers and other stakeholders to properly evaluate the desirability of such proposed changes without a stated policy rationale. Policymakers will need to determine whether the policy aims furthered by the proposals outweigh the costs in terms of increased complexity and departures from neutrality inherent in the rules, and will need to decide among the various options proposed. Second, a stated policy rationale can be useful as an interpretive aid if the Recommended Rules are adopted. As discussed in more detail below, the Discussion Draft acknowledges difficulties in delineating the proper scope of the Recommended Rules. Given these difficulties in scoping the Recommended Rules, we believe it is important to articulate a robust policy rationale that would help decide in particular cases whether an instrument or arrangement is appropriately subject to the Recommended Rules.

The Discussion Draft does not articulate a clear policy for distinguishing between the effects of hybrid mismatch arrangements and other mismatches caused by differences in domestic tax policy. Although the Discussion Draft limits its focus to mismatches that are attributable to the hybrid element in an arrangement, it does not explain why cross-border mismatches arising from hybridity have a uniquely detrimental effect as compared to other types of cross-border mismatches. For example, a mismatch may occur as a result of differences in tax rates between two jurisdictions or because two jurisdictions recognize the timing of payments differently. Or, as the Discussion Draft acknowledges, a mismatch may occur because a jurisdiction grants "deemed" interest deductions for equity. *See* para 22. Hybrid mismatches and other mismatches may arise from well considered tax and economic policy decisions by each jurisdiction. A clear policy rationale for targeting hybrid mismatch arrangements is important because the Recommended Rules would increase the complexity of domestic tax systems and would require domestic tax law to depart from the principle of neutrality. Under the Recommended Rules, for example, domestic tax law would treat taxpayers differently, even in the case of identical instruments, by conditioning the availability of a deduction depending on whether the payee is domestic or foreign, or whether the payee is taxed or not taxed as a result of hybridity.

Additionally, the Discussion Draft does not justify the implicit judgments regarding the appropriate allocation of taxing rights in the context of hybrid mismatch arrangements. The absence of any articulated policy may make it difficult for policymakers to determine the extent to which to adopt the rules, producing variations across jurisdictions and creating even more complexity.

In general, a hybrid mismatch occurs because the countries on each side of an arrangement have determined that it is appropriate to provide a benefit to taxpayers under domestic law (*i.e.*, a deduction or exclusion). Because each jurisdiction has provided such tax benefit under its domestic law, the arrangement results (in the words of the Discussion Draft) in a double deduction or deduction/no inclusion. The Recommended Rules intend that one of the countries depart from its domestic tax policy and deny an otherwise available deduction or exclusion based on the domestic tax policy decisions of the other jurisdiction. The Discussion Draft generally does not express a view as to which jurisdiction should do so, and indeed explicitly avoids the question of which jurisdiction's tax base is being eroded. But the question of taxing jurisdiction raises fundamental domestic tax policy questions for each jurisdiction, and has revenue implications for the countries involved. These questions should not be decided merely on the basis of ease of administration, particularly in the related party and structured arrangement context to which the rules generally should be limited. Once it is agreed that one jurisdiction should depart from its generally applicable rules in evaluating hybrid mismatch arrangements, it may be important for each jurisdiction involved to make an explicit policy judgment as to which domestic law should prevail. Again, a clear policy rationale for the recommendations as to which jurisdiction should depart from its generally applicable domestic law and tax a payment arising from a hybrid mismatch arrangement would help policymakers determine whether and how to adopt the Recommended Rules, increase the likelihood of more uniform adoption of the rules, and help provide resolutions in specific cases.

Accordingly, we recommend that the OECD provide a fuller articulation of the policy basis underlying the Recommended Rules, including the implicit division of taxing jurisdiction, so that the advisability and content of the Recommended Rules can be better evaluated.

The Recommended Rules Could Result in Double Taxation

The Recommended Rules could result in double taxation in several ways. For example, the Discussion Draft generally does not take into account whether the jurisdiction permitting a deduction for an outbound payment imposes a withholding tax on that payment. This oversight is perplexing given the traditional role of withholding taxes in preventing base erosion. The imposition of a withholding tax could be equivalent from a policy perspective to the denial of a deduction by the jurisdiction of the payer or to the taxation of the payment as income by the jurisdiction of the payee.

As another example, the Discussion Draft recommends that a hybrid mismatch rule that limits interest deductibility would apply before the application of any general non-transaction specific limitation such as a thin capitalization rule. *See* para. 241. Under this approach, the jurisdiction of the payee would determine whether the payer is entitled to claim a deduction for the payment before the application of thin capitalization rules, and therefore could require the payee to include the payment as ordinary income even if the payer ultimately is not entitled to a deduction. There is no policy basis for this result; the payer jurisdiction is entitled to determine whether its thin capitalization or other rules are sufficient to prevent the erosion of its tax base through outbound deductible payments on financial instruments. While taking into account thin capitalization rules and other non-transaction specific rules can be complex, the Recommended Rules are already tremendously complex and would require countries to make inquiries regarding the domestic tax law of other countries. To extent general limits on deductibility apply, the transaction does not result in a deduction/no inclusion scenario.

Finally, the Discussion Draft does not take into account whether income from a hybrid instrument is taxable under CFC rules in the investor jurisdiction. The Discussion Draft states that taking into account taxability under CFC rules presents "concerns about workability and complexity." *See* para. 36. As noted above, however, the Recommended Rules are already tremendously complex and would require countries to make inquiries regarding the domestic tax law of other countries and adapt their own domestic law accordingly. Given the existing level of complexity, requiring further inquiry into the CFC rules of the investor jurisdiction would not present unacceptable complexity, and would be an important step towards reducing double taxation. To the extent that income is taxed under CFC rules, the transaction does not truly result in a deduction/no inclusion scenario.

We note that the interaction between the Recommended Rules and other action items, including the action item on interest deductibility and CFC rules, merits further study consistent with our recommendation that the substance and timing or related action items be better coordinated. The observations in the two preceding paragraphs present examples of issues that should be worked through in a comprehensive manner.

Specific Comments on Discussion Draft

Hybrid Financial Instruments & Transfers Rules Should Adopt a Bottom-up Approach

The Discussion Draft provides two approaches to drafting a scoping rule – a bottom-up approach whereby the rules apply only to identify categories of instruments, and a top-down approach whereby the rules apply to all instruments other than those excepted. *See* paras. 118-120. Because the Recommended Rules are complex, will be difficult to comply with and administer, and will represent a departure from traditional tax norms such as neutrality, we strongly endorse a bottom-up approach. The OECD should identify the categories of instruments to which the rules apply.

Hybrid Financial Instruments & Transfers Rules Should Be Limited to Related Party and Structured Arrangements

In addition, we recommend that the rules be limited to related party arrangements and highly structured arrangements. As a policy matter, the rules should not apply to instruments issued to the public or otherwise widely held or traded because there is no profit shifting in such circumstances. As the Discussion Draft notes, there would be significant administrative challenges in extending the rules to widely-held or traded instruments, and we believe that those difficulties are disproportionate to any perceived benefit gained from having such broad rules. Domestic tax rules that link the tax treatment of an item to its treatment in another jurisdiction are complex, and the limited precedents for such rules provided by the Discussion Draft (e.g., CFC rules and the foreign tax credit) generally involve related party contexts. *See* para. 6. Even if such administrative difficulties could be overcome, we do not believe it is sound tax policy to apply these rules to widely-held or traded instruments merely because two or more countries have chosen, as a matter of their tax and economic policy, to treat such instruments in different ways. The case in this context for distinguishing hybrid mismatches from other mismatches, such as tax rate or timing mismatches, is not clear.

Moreover, we recommend that the standard for determining whether parties are related should be consistent across the rules and should be common control, *i.e.* 50 percent or more common ownership.

Hybrid Financial Instruments & Transfers Rules Should be Limited to Debt and Equity

We also recommend that the hybrid mismatch rules be limited to instruments or transfers that are treated by the residence jurisdiction of at least one of the parties to the arrangement as debt or equity of an affiliate, or perhaps in specified cases to agreements to acquire or transfer the debt or equity in an affiliate. Such a limitation would be consistent with the types of transactions described in the Discussion Draft, and would reduce uncertainty as to the potential scope of the rules. The rules should not be drafted in a manner that all financial instruments must be tested against it. Otherwise, taxpayers that have not entered into the kinds of hybrid mismatch arrangements identified in the Discussion Draft would be subject to unnecessary and burdensome compliance costs and uncertainty. *See* para. 43.

Dual Inclusion Income Rules Should Be Refined to Prevent Double Taxation

The hybrid payment rules described in the Discussion Draft could result in double taxation if "dual inclusion income" is defined too narrowly. The Recommended Rules provide that a duplicate deduction should be denied to the extent it exceeds the taxpayer's dual inclusion income. The Discussion Draft correctly notes, however, that in order to address mismatches that result merely from timing differences, taxpayers should be permitted to carry forward denied deductions to offset future dual inclusion income. *See* para. 190(b). In addition, we recommend that taxpayers be permitted to carry back a duplicate deduction to the extent a hybrid entity has generated dual inclusion income in the past. Under U.S. law, for example, in a similar fact pattern, a taxpayer is entitled to take a current deduction for an excess loss to the extent the hybrid entity has previously generated dual inclusion income. If a duplicate deduction could not be carried back to offset dual inclusion income in prior years, deferral of the deduction could result in double taxation (in part, or even in whole if, for example, the entity never utilizes all of its carry forwards). We do not find a compelling policy reason to distinguish between carrybacks and carry forwards so long as the taxpayer's income is subject to tax in both jurisdictions.

Imported Mismatch and Reverse Hybrid Rules Should Be Reconsidered

The Discussion Draft proposes a system of primary, secondary, and defensive rules to address imported mismatches and reverse hybrids. These rules seem unduly complex and should be reconsidered.

The issues identified by the Discussion Draft with respect to imported mismatches appear to relate to back-to-back or conduit financing arrangements, and may be better addressed through rules targeted to conduit financing arrangements. We recommend that the OECD reconsider the approach to these arrangements and either eliminate the proposed rules with respect to imported mismatches or replace those rules with targeted anti-conduit rules.

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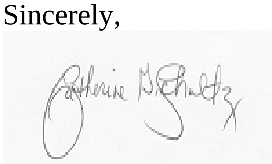
The issues identified by the Discussion Draft with respect to reverse hybrids seem better addressed by the payer jurisdiction considering the imposition of a withholding tax on outbound payments of deductible interest, royalties, or similar payments, and reducing or eliminating that withholding tax by treaty (or otherwise) subject to a rule consistent with the principles of proposed Article 1(2) of the Discussion Draft on Hybrid Mismatch Arrangements (Treaty Issues).[1] Under this rule, the payer jurisdiction in example in Figure 11 would permit a deduction but impose a withholding tax on the interest even if there were tax treaties between each of the relevant countries because the interest income would be derived through a fiscally transparent entity and not considered to be the income of a resident by either the intermediary jurisdiction or the resident jurisdiction. If the payer jurisdiction failed to provide for such a rule, the residence jurisdiction would be free to tax the payment under its CFC rules consistent with its domestic law policy preferences. There is no need to recommend rules for the intermediary jurisdiction in this context as such rules would be unnecessarily complex and would not seem to address the hybrid mismatch more effectively than the rules suggested above.

To the extent that the OECD recommends rules that address imported mismatches, through an anti-conduit rule or otherwise, we agree with the suggestion in the Discussion Draft that the rules for an imported mismatch should be limited to transactions that occur within a control group, defined as 50% or more common ownership. *See* para. 233. Furthermore, if the OECD recommends that imported mismatches be prevented by means of limitations on deductions or exemptions, then rules should take into account CFC rules of the investor jurisdiction in order to prevent double taxation, as discussed above.

Sincerely,



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1 We do not necessarily endorse proposed Article 1(2) in its totality, in particular its application to "arrangements" in addition to entities, and its potential application to income other than investment income (dividends, interest, and royalties) or gains.