UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

February 26, 2019

Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20044

RE: IRS REG-104352-18 - Guidance Related to Section 245A(e) and 267A (Rules Regarding Certain Hybrid Arrangements)

Dear Commissioner Rettig:

USCIB[1] is pleased to provide comments on the proposed regulations regarding guidance related to rules regarding certain hybrid arrangements under sections 245A(e) and 267A (REG-104352-18).

General Comments

The proposed regulations are largely based on the OECD's two Action 2 Final Reports.[2] While USCIB does not agree with all the decisions of these reports, we understand that the U.S. government supported these consensus reports and therefore it may be considered a rejection of the U.S. government's international commitments for the hybrid regulations to stray too far from the OECD's hybrid reports. USCIB therefore does not question aspects of the regulations that we might otherwise disagree with.

Sticking to the international consensus has value for business. To the extent the OECD consensus reflects business input and benefits business, moving away from that consensus may undercut the negotiated benefits business argued for and which governments accepted. USCIB, therefore, urges governments to stick to the consensus and not to adopt unilateral measures that are inconsistent with the international consensus that they agreed to.[3] Furthermore, sticking to the consensus means rules are more uniform and compliance is simpler. The specific comments below identify areas where we believe the regulations depart from the international consensus and undercut that agreement.

The proposed regulations would generally apply to taxable years beginning after December 31, 2017. The proposed regulations are technically very complex and will be difficult to administer both for taxpayers and the government. Business pointed this out during the development of the OECD's hybrid reports.

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide and works to facilitate international trade and investment.

[2] Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report (October 2015) and Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS (July 2017).

[3] There are many examples of this. These include: the country-by-country reporting standards and the requirement that the countries do not expand the required data and that they keep that data private, the conclusion that the digitalizing economy cannot be ring-fenced.

The response to that comment by the U.S. government (and others) was that to avoid the complexity business should eliminate their hybrid structures and avoid setting up new ones. Many businesses have been taking this path, but restructuring may take time and businesses are in the process of examining their structures in light of these regulations to determine whether restructuring is needed (or possible). Further, the EU has adopted its second Anti-Tax Avoidance Directive with an effective date of January 1, 2020. This directive applies to hybrid mismatches that are external to the EU, for example, between a European company and a U.S. company. USCIB, therefore, recommends that the proposed regulations be made applicable for taxable years beginning after December 31, 2019. That should provide taxpayers time to evaluate and restructure where possible and coordinate with the implementation of ATAD II. Those taxpayers with hybrids in place after 2019 will have had time to set-up systems to comply with the regulations.

Specific Comments

Notional Interest Deductions

The proposed regulations make a significant departure from the OECD consensus guidance with respect to the treatment of notional interest deductions ("NID"). The 2015 Action 2 Final Report contains the only guidance on NID. This is a very brief discussion which concluded that deemed interest deductions do not produce a mismatch in tax outcomes.[4] The Final Report notes that such rules will, however, be considered separately in the context of the implementation of these recommendations. To date there has been no further consideration of the treatment of NID by the OECD. The OECD consensus reached the correct conclusion on the treatment of notional interest deductions – they do not create a mismatch; the U.S. government should stick to the consensus agreement on this issue.

Notional interest deductions were not treated as producing a hybrid mismatch for a number of reasons. The principle objection by OECD members to the benefits obtained by hybrid tax planning related to the unintended nature of those benefits. Taxpayers were perceived as planning into "gaps" in the system that arose because countries tax rules are not identical, and the taxpayer could choose the structure of the transaction to take advantage of those gaps. This is apparent from the structure of the 2015 Final Report. It applies to payments. It contains primary rules (disallow the deduction) and defensive rules (force an inclusion). Both countries should see a mismatch that needs to be addressed. In the case of notional interest deductions, the primary rule would never apply; the country granting the NID will not disallow the deduction because the deduction is intentional. There is, therefore, no risk that the tax base of the NID country will be unintentionally narrowed.

Countries that grant notional interest deductions with respect to equity are choosing to provide a benefit to equity based on a desire to encourage equity funding, which is more stable than debt in times of an economic downturn or crisis. Thus, legitimate concerns with over-leveraging in the economy often drives a country's decision to adopt a notional interest deduction.

In effect, notional interest deduction is equivalent to a lower tax rate on profits and not a hybrid deduction. Countries are free to choose their corporate income tax rate, so a reduction in that rate achieved by an NID should not be considered to violate the hybrid rules. Rather, the GILTI tax regime is the appropriate backstop on tax rate reductions effected by NID. The notional interest deduction reduces foreign tax but has no effect on the calculation of a taxpayer's GILTI amount. Therefore if income is subject

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[4] Action 2 2015 Final Report, paragraph 11 (pages 17 and 18).

to an unacceptably low rate of foreign tax because of the NID, an appropriate remedy already exists under the GILTI rules. The hybrid regulations should function to prevent the mismatches as identified in the 2015 Final Report, not serve as a backstop to the GILTI regulations.

Treating NID as hybrids places the U.S. outside of the international consensus and disadvantages U.S.-based multinationals as compared with non-U.S. companies. It is therefore highly important for Treasury to consider the effect of these regulations on the competitiveness of U.S. companies in a global market as compared with the risk of hybrid tax planning. Under the proposed regulations, if a U.S.-based multinational and a non-U.S. based multinational compete in a NID country, the U.S.-based multinational would incur an additional layer of U.S. tax on profits otherwise offset by NID, while the non-U.S. company would enjoy a reduced foreign tax rate effected by the notional interest deduction. Thus, the competitiveness of the U.S.-based multinational in the NID country is harmed merely because of its U.S. ties, even though it does not engage in hybrid tax planning.

The government did not articulate a rationale for treating NID as subject to the hybrid rules; they simply assert that NID raise similar concerns to traditional hybrid instruments with no further elaboration. As described above, this misunderstands the legitimate policy goals of NID and the concern with hybrid instruments under the consensus of OECD member countries– namely that they take advantage of unintended mismatches or gaps between tax systems. In the case of NID, there is no mismatch, no hybrid instrument, and no reason to apply the hybrid rules.

<u>Definition of Hybrid Transaction</u>

Section 267A(c) defines a hybrid transaction as follows:

> For purposes of this section, the term "hybrid transaction" means any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for purposes of this chapter and which are not so treated for purposes the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax.

Under this definition, a hybrid transaction is described as having two elements: a payment and hybridity. The 2015 OECD report is very clear that the hybrid mismatch rules only apply to payments. The definition of a payment explicitly states that it does not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between parties.[5] Further, the starting point in applying the hybrid mismatch rules is to look for the legal basis for the deduction to determine whether the deduction relates to an actual expenditure or transfer of value rather than it being a purely notional amount for tax purposes.[6] The intent of these statements in the OECD report is well defined as they also provide specific examples on this point related to deemed deductions from interest free loans which conclude that payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between the parties are specifically excluded from the definition of a payment.[7]

[5] Action 2 2015 Final Report, Chapter 12, Other Definitions (page 123).
[6] Action 2 2015 Final Report, paragraph 391 (page 125).
[7] Action 2 2015 Final Report, Examples 1.13 and 1.14 (pages 213-218).

Hybridity is also central to the definition such that if two countries both treat a payment as interest, for example, then definitionally the transaction is not a hybrid transaction and cannot be subject to section 267A. The Treasury and the IRS have expanded the definition of hybrid transaction to cover transactions that are clearly not hybrid transactions under this rule. Proposed regulation §1.267A-2(a)(2) defines a hybrid transaction and the first part of that paragraph is consistent with the statutory definition. However, the proposed regulation provides:

> In addition, a specified payment is deemed to be made pursuant to a hybrid transaction if the taxable year in which a specified recipient recognizes the payment under its tax law ends more than 36 months after the end of the taxable year in which the specified party would be allowed a deduction for the payment under U.S. tax law.

There is no basis for this position. The statute is clear that hybridity requires a distinction based on the character of a payment. Thus, if both countries treat the payment as interest, then the amount of time between the deduction and the inclusion cannot serve as a basis for treating the transaction as a hybrid transaction. Further, this position goes beyond the granted regulatory authority under Section 267(A)(e).

Additionally, this position further departs from the OECD's intentions. The Action 2 Report states that in general, differences in timing do not give rise to a hybrid financial instrument and that a payment will not be treated as a hybrid payment so long as the payment is expected to be included in income within a reasonable period of time.[8] This standard is defined as the time period that might be expected to be agreed between unrelated parties acting at arm's length.[9]

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)

[8] Action 2 2015 Final Report, paragraph 55 (page 34).
[9] Action 2 2015 Final Report, paragraph 58 (page 34).

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