Report No. 1305

April 11, 2014

THE NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMENTS ON "THE PUBLIC DISCUSSION DRAFT OF BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS (RECOMMENDATIONS FOR DOMESTIC LAWS)" (THE "CONSULTATION DOCUMENT")

The Tax Section of the New York State Bar Association (the "Tax Section") is submitting these comments regarding certain aspects of the Consultation Document's proposals regarding hybrid financial instruments and transfers.[1] In pursuance of its mission of furthering a fair and equitable tax system, the Tax Section submits approximately 25 comment letters and reports each year to the U.S. Congress, Treasury Department and Internal Revenue Service or to the New York legislature and tax authorities regarding proposed legislation, regulations and other tax matters. These comment letters and reports are prepared by knowledgeable practitioners, and are reviewed and approved by the Executive and Administrative Committees of the Tax Section, under strict conflict of interest rules intended to ensure that the recommendations reflect the considered judgment of the Tax Section and are not influenced by client interests. We are submitting this letter, which has been prepared in accordance with the foregoing guidelines based on our experience with the international capital markets and our knowledge of hybrid financial instruments and transfers, because of the importance of the issues addressed by the Consultation Document.[2]

Top-Down vs. Bottom-Up Approach

The Consultation Document describes two possible approaches for neutralizing the effect of hybrid financial instruments and transfers – a bottom-up and a top-down approach, and suggests that, "Ultimately the difference between a top-down or bottom-up approach may

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[1] These comments were prepared by an *ad hoc* committee of the Tax Section. The principal author was Yaron Z. Reich. Helpful comments were received from Kimberly S. Blanchard, Michael Farber, David Hardy, Stephen B. Land, Michael L. Schler, David H. Schnabel, David R. Sicular and Alison J. Stoffregen. These comments reflect solely the views of the Tax Section and not those of the New York State Bar Association Executive Committee or the House of Delegates. These comments may be cited as New York State Bar Association Tax Section Report No. 1305, "Comments on 'The Public Discussion Draft of BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)'" (April 11, 2014).

[2] Often the U.S. Treasury Department requests our views regarding an issue. In this case, the Treasury Department asked for our views regarding the top-down vs. the bottom-up approach.

not produce a significant difference in terms of outcome or mechanics."[3] We are skeptical about that conclusion, and have serious concerns regarding the scope, administrability and compliance costs of the top-down approach. Our concerns are based on the following considerations:

1. *The Choice of Scope Filters*. The top-down and the bottom-up approaches both start with the same basic definition of a hybrid financial instrument and transfer, and apply the same "linking" rule, under which the tax outcomes for the issuer and the payee are aligned (either denial of a deduction to the issuer or inclusion of income by the payee).[4] Thus, in order to apply the hybrid financial instrument and transfer rule, the issuer and/or the payee needs to know the identity of the other party and information regarding the tax treatment of the instrument by that party's taxing jurisdiction.

The difference between the bottom-up and top-down approaches is that the bottom-up approach would apply the hybrid financial instrument and transfer rule only to instruments held by related persons (including persons acting in concert) and to any instrument that was part of a structured arrangement designed to produce a mismatch.[5] By contrast, the top-down approach would apply the rule to every hybrid instrument or transfer except in the case of widely-held and traded instruments (although this exception would not apply to related persons or structured arrangements) and other unspecified situations where it would be unduly burdensome for the taxpayer to comply with the rule.[6]

Thus, whereas the bottom-up approach seeks to apply a "filter" that limits the scope of the hybrid financial instrument and transfer rule to "those transactions which raise the most significant concerns from a tax policy perspective,"[7] the top-down approach seeks to apply the rule broadly and to exclude only those transactions "where it would be impossible or unduly burdensome for the taxpayer to comply with the rule."[8] As explained below, we do not believe that it is practicable to define widely-held or traded instruments in a way that would address the compliance and administrability challenges and burdens described in the Consultation Document[9] or to craft an alternative filter for a top-down approach that is based on minimizing compliance burdens. On the other hand, we believe that while there are challenges in appropriately defining related persons and structured arrangements, in concept those filters under

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[3] Paragraph 121. Unless otherwise indicated, all paragraph references are to the Consultation Document.

[4] Paragraph 81 and the box immediately thereafter. The Consultation Document uses the undefined terms "issuer," "holder," "owner" and "beneficial owner," as well as the defined terms "payer" and "payee." Payee is defined in paragraphs 237 - 240 based on the context of the question, but as used herein would be the person whose tax treatment of the payment received is relevant under the laws of its jurisdiction to determine whether there is a hybrid mismatch (*i.e.,* the beneficial owner, in non-technical parlance).

[5] Paragraph 119.

[6] Paragraphs 120, 139, 147, 149.

[7] Paragraph 119.

[8] Paragraph 120.

[9] *See* paragraphs 142 – 157.

the bottom-up approach fairly cover the scope of transactions that may be considered problematic from a tax policy perspective.

2. *Most Debt is Traded Over-the-Counter and the Issuer Usually Does Not Know the Number or Identity of the Holders or Payees*. The Consultation Document states:

> "A widely-held instrument is one that is held by a large number of holders across a number of jurisdictions and it would include a widely-held and regularly traded bond. Any test for widely-held would need to account for instruments held through custodians and other arrangements where it may be difficult for the issuer to determine who holds the instrument and in what proportions."[10]

In 2010, the Tax Section prepared a description of how debt instruments are traded and their trading platforms.[11] Based on that description and our knowledge of the capital markets, we offer some comments relevant to the definition of a widely-held or traded debt instrument.

Whereas in Europe it is common to list debt instruments on a securities exchange even if they are held by only a handful of investors, very few issuances of debt instruments in the United States are listed on a securities exchange, and they typically are placed through or with banks, securities firms, insurance companies, hedge funds and other institutional investors. On both sides of the Atlantic, however, even for debt instruments that are listed on a securities exchange – as well as for all others – the vast majority of the number and volume of trades after their initial issuance takes place over-the-counter (*i.e.,* by or through financial institutions that make markets in those debt instruments), in large blocks in privately negotiated transactions. Thus, it would not be fruitful to determine whether a debt instrument is widely-held or traded based on whether it is listed on a securities exchange.

Very often, the initial placement of a debt instrument may be with a limited group of financial institutions or other institutional investors, which thereafter (usually but not necessarily as part of the initial placement) sell portions thereof or interests therein to other investors. Usually, the issuer does not know the number or identity of the holders or payees because the debt instruments are held through custodians or other financial institutions. In the case of bank loans, the issuer typically does not know the number or identity of many of the holders or payees because a named lender may transfer interests in the loan through loan participations, which are agreements between it and its transferee and are not disclosed to the issuer.

Indeed, because financial institutions are reluctant to identify their customers to their competitors, the U.S. tax information reporting system (for domestic, foreign withholding

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[10] Paragraph 147. The Consultation Document also indicates (in paragraph 148) that an instrument that is widely-held "will typically be offered to the public."

[11] New York State Bar Association Tax Section, "Report on Definition of 'Traded on an Established Securities Market' Within the Meaning of Section 1273 and Related Issues," Appendix (March 30, 2010), *available at* http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1209Rpt.pdf.

and FATCA purposes) is structured to facilitate direct reporting to the Internal Revenue Service rather than reporting beneficial ownership through chains of intermediate holders, which also makes it difficult if not impossible for issuers to identify the payees of their debt instruments.

There are various services – including electronic databases available to market participants – that track and report trading in bonds and other debt instruments in which there is a sufficiently robust market, as well as dealers willing to provide fixed or indicative quotes for such debt instruments. The Internal Revenue Service took account of current market practices in this regard when it amended its regulations in 2013 to provide, in general, that a debt instrument is "traded on an established securities market" for purposes of determining its issue price and amount of original issue discount (if any) under section 1273 of the U.S. Internal Revenue Code if, within 15 days before or after its issue date, there are actual sales prices reported on a medium made available to market participants, or fixed or indicative sales quotes are available from a dealer (subject to certain exceptions, including for any issue that does not exceed $100 million).[12] These regulations take a very expansive view of when a debt instrument is publicly traded.

In theory the regulations under U.S. Internal Revenue Code section 1273 might serve as a basis for crafting a definition of "widely-held or traded" for purposes of the top-down approach, based on the concept that if actual sales information or fixed or indicative sales quotes for a debt instrument are being disseminated or made available to market participants, that instrument should be considered widely-held or traded (even if the issue is $100 million or less). However, even if the OECD were willing to adopt such an expansive definition, most issuers generally do not have access to these databases and other information media, which often are offered by the services or dealers to their customers for a fee, and thus in many cases would not be able to determine whether particular debt instruments satisfied the conditions for being widely-held or traded. And in any event, the issuers generally would not know the number or identity of the holders or payees if that information were necessary to comply with the hybrid financial instrument rule under the top-down approach (as the Consultation Document suggests would be the case in many instances), and would not even know whether the instrument "is held by a large number of holders across a number of jurisdictions," as contemplated in the Consultation Draft's conception of a widely-held instrument, because that information is simply not captured by these databases and other information media.

3. *Application to ordinary lending transactions between unrelated persons*. The Consultation Document correctly notes that, "One challenge in formulating a top-down approach is that it brings in a number of ordinary lending arrangements that may present little risk from a hybrid mismatch perspective,"[13] and will "impose compliance obligations on every person who is a party to an instrument unless those instruments are carved out of scope."[14]

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[12] *See* U.S. Treasury regulations section 1.1273-2(f).

[13] Paragraph 141.

[14] Paragraph 142.

For example, conventional bank loan participations could be subject to the hybrid financial instruments rule because they may be subject to different characterizations in some countries. Another class of conventional debt instruments that could be implicated under the rules would be convertible securities. Also, absent a broad exclusion (which presumably would not easily distinguish ordinary from abusive situations), the rule could create significant compliance issues for issuers and holders of Islamic law-compliant debt instruments that are not designed to produce a hybrid tax benefit, because those debt instruments are typically documented as sale-and-repurchase transactions or as other forms of hybrid financial transactions. But the rule could apply to virtually any debt instrument, since its treatment under a particular holder's tax laws could trigger the application of the hybrid financial instruments rule.

Indeed, absent a broad exclusion, the top-down approach would appear to apply to the enormous, highly liquid and high-volume market of repos and securities loans of government securities and corporate bonds, notwithstanding that the terms are standardized and the pricing is competitive, transparent and not affected by hybrid tax benefits.[15]

We are concerned that any rule that generally requires large numbers of unrelated issuers and holders of a wide and indeterminate range of conventional debt instruments, such as bank loan participations, convertible securities, Islamic law-compliant securities, and conventional repos and securities loans, in the capital markets to adopt compliance measures relating to the hybrid rules – and perhaps to forgo the anticipated tax treatment – in the absence of a structured arrangement, could be a very costly and troublesome development for the capital markets.[16]

The solutions suggested by the Consultation Document for the gross over-breadth of the top-down approach – enhanced communication between issuers and holders of such debt instruments or technical safe harbor exclusions – are to our mind inadequate alternatives to crafting workable, appropriate filters for the hybrid financial instruments rule, as indeed the bottom-up approach can do. Nor are we confident that a comprehensive set of exclusions that would effectively carve out all categories of transactions where compliance is not practicable can be crafted.

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[15] The Consultation Draft (paragraphs 76 – 80 and Figure 3) describes a bond lending repo involving a double dip of withholding tax credits. But it appears that a conventional repo that was not intended to produce any tax benefits could also be a hybrid financial instrument where Country A (in Figure 3) treats the repo as a secured loan while Country B treats the repo in accordance with its form as a purchase and resale transaction, since the relevant "payment" is the interest deduction claimed by A Co, which may be treated as gain that is not "ordinary income" by Country B, as those terms are defined in the Consultation Draft.

In our view, as discussed under Specific Recommendations, point 3, below, conventional repos and securities loans involving government or corporate securities – where the terms are standardized and the pricing is competitive, transparent and not affected by hybrid tax benefits – should not be treated as structured arrangements under the bottom-up approach. On the other hand, a collateralized loan repo (paragraphs 66 – 73), or a bond lending repo giving rise to a tax credit double dip (paragraphs 76 – 80), that is structured and priced to benefit from hybrid tax benefits, should be a structured arrangement.

[16] For an indication of the compliance burdens and costs that would be involved, *see* paragraphs 142 – 157 as well as Specific Recommendations, point 2, below.

4. *Perfection vs. practicality*. To a great degree, the top-down and bottom-up approaches appear to differ in their view regarding the scope of the problem to be addressed. The top-down approach appears to reflect the perspective that all hybrid mismatches are potentially corrosive to the international tax system and must be eradicated to the extent that doing so does not impose unacceptable collateral costs, whereas the bottom-up approach appears to view hybrid mismatches as problematic only where they are intentionally designed to achieve D/NI (a deduction without inclusion) or DD (a double deduction) – *i.e.,* in structured arrangements or (irrebuttably) between related persons.

While we acknowledge that reasonable minds may differ on the scope of the problem and that in any event the Consultation Document is not soliciting opinions on that policy question, we do not believe that "unintended" or "accidental" hybrid mismatches[17] (including those relating to conventional debt instruments of the sort described in point 3 above), that are not structured arrangements and which generally arise from the correlative effect of commercial, non-tax driven transactions under different tax systems, implicate serious tax policy concerns. Indeed, given that such hybrid results are a necessary and expected by-product of the lack of uniformity among domestic tax rules around the world, we see little reason to treat hybrid tax results more severely than natural, unintended or accidental disparate tax-accounting or tax-regulatory results. Moreover, we note that most tax systems knowingly accept domestic D/NI mismatches in the treatment of debt instruments that enable taxable issuers to deduct interest payments notwithstanding that tax-exempt holders are not taxed on the income.

Regardless of one's opinion on this policy question, however, we respectfully submit that the marginal benefits of expanding the hybrid mismatch rule beyond related persons and structured transactions are outweighed by the compliance costs and burdens under the top-down approach. Even if there were a broad exception for widely-held and traded debt instruments, so long as the hybrid financial instruments rule covers meaningful numbers of instruments that are held by persons that are unrelated to the issuer and that did not engage in structured arrangements with the issuer, it would be necessary to develop and put in effect a complex information reporting system in order for issuers and holders of hybrid financial instruments to comply with the top-down approach.[18] While sharing of information would also be necessary under the bottom-up approach, this is not objectionable or overly burdensome where the requirement is imposed only on related persons and persons that have intentionally structured and entered into a tax avoidance arrangement (provided those terms are defined as set forth under Specific Recommendations, below).

Specific Recommendations

1. *Adopt the bottom-up approach*. For the reasons set forth above, we support the adoption of the bottom-up approach.

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[17] These terms are used in the Consultation Document; *see, e.g.*, paragraph 119.

[18] *See* Specific Recommendations, point 2, below for some of the complexities that would be involved.

2. *Related persons*. The threshold for relatedness should be increased from 10 percent to 50 percent.[19] We believe that the reasons for subjecting a hybrid financial instrument held by a related person to the hybrid mismatch rule are that (i) hybrid instruments have often been used within multinational groups -- where the cross-ownership is invariably much greater than 50 percent – to achieve tax arbitrage benefits, (ii) there is thus a reason to adopt an irrebuttable presumption that such a transaction was structured for tax avoidance reasons and (iii) doing so should not raise any serious compliance problems. However, in the absence of indicia of a structured arrangement (which in any event would be picked up under the structured arrangement prong of the test), we are not aware of hybrid financial instruments being held with any frequency outside of multinational groups (other than in conventional commercial settings of the type described under Top-Down vs. Bottom-Up Approach, point 3, above, in which the hybrid result is "unintended" or "accidental").

Moreover, there would be serious compliance costs and burdens if all issuers, holders and payees of financial instruments were required to determine, as to each such financial instrument (i) whether there is any person in which a greater-than-10-percent interest (by voting rights or value) is owned, directly or indirectly, by one or the other such person, or by a third person in both of them, or by persons acting in concert, (ii) whether such financial instrument is a hybrid instrument as to any such person due to the disparity in treatment between the issuer and payee's tax jurisdiction[20] and (iii) share relevant information with any such person(s) to enable the issuer and/or payee to properly comply with the relevant hybrid financial instrument rules as adopted in their respective jurisdictions.[21] As the Consultation Document acknowledges, there are no information exchange mechanisms currently in place that would make the necessary information available, and there are serious challenges and costs in developing such mechanisms.[22]

If there is lingering concern about situations involving cross-ownership below 50 percent, the structured arrangement definition might be expanded to include as a rebuttable factor cases involving, say, 25 percent or greater cross-ownership.

Finally, with respect to the application of the related person rule to intra-group hybrid instruments that mirror hybrid regulatory capital instruments issued to unrelated investors in order to pass down the tax effect of the issuer's deduction to the ultimate borrower in the

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[19] It is noteworthy that the Consultation Document adopts a 50% threshold in its proposed "control group" test for imported mismatches and reverse hybrids (*see* paragraph 233).

[20] In the case of a direct or indirect holder that is an entity, this inquiry will entail a determination whether the entity is tax-transparent under the tax rules applicable to any owner of an interest in the entity, and then whether the financial instrument is a hybrid financial instrument under the tax rules applicable to such owner (or if it in turn is an entity, under the tax rules applicable to the ultimate payee), with the relevant owners depending upon whether the entity or the owner is the person with the 10% ownership relationship to the issuer.

[21] As a result of the primary and secondary rules plus the dividend exemption rule (see box following paragraph 81), quite a bit of back-and-forth information and/or analysis may be necessary for the issuer and payee to determine the proper treatment under the applicable rules.

[22] *See* paragraphs 143, 152, 154, 156. *See also* Top Down vs. Bottom-Up Approach, point 2, above.

group, we agree with the Consultation Document's suggestion (in paragraph 162) that this situation merits consideration for special relief.

3. *Structured arrangements*. The definition of a structured arrangement needs to be clear and understandable, especially if financial instruments that are issued to investors in the capital markets – and not only privately negotiated transactions – could be subject to the hybrid financial instruments rule if they are issued pursuant to a structured arrangement intended to benefit from hybrid tax treatment, so that issuers, investors and underwriters are not faced with economic uncertainty or the need to seek information that often will not be feasible to obtain.

We believe that the touchstone of whether there is a structured arrangement should be whether the pricing of the financial instrument at the time of its initial issuance took into account sharing of the (expected) tax benefit of the hybrid mismatch. Often such pricing effect will be evidenced in pricing models, other internal documents or communications between the parties (in the case of private transactions) or with the underwriter or banker (in the case of public or intermediated transactions). While other factors, including the indicators listed in paragraph 132, may in appropriate circumstances objectively establish that the hybrid tax benefit affected the pricing of the transaction, in the absence of strong evidence of such an impact the transaction should not be a structured arrangement.

Thus, an example of a case that should not be a structured arrangement is a debt issuance that is primarily targeted and sold to a tax-exempt domestic investor base (and priced on that basis) where, say, 10% of the issue is acquired by unrelated persons who benefit from hybrid treatment in their countries of residence. On the other hand, a public debt issuance that is targeted to a particular country that provides investors with hybrid tax benefits, so that the issuer can achieve more attractive pricing, should be a structured arrangement.

Under the standard for structured arrangements discussed herein, we believe that the parties to a conventional repo or securities loan of a government or corporate security entered into on market terms should not need to be concerned about the potential applicability of the hybrid financial instruments (and transfers) rule because the terms are standardized and the pricing is competitive, transparent and not affected by hybrid tax benefits. On the other hand, a collateralized loan repo of the sort discussed in paragraphs 66 – 73 would be a structured arrangement.