15 July 2011

Mr Jeffrey Owens
Director, CTPA
OECD
2, rue André Pascal
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France

Dear Mr Owens,

AFME initial comments on the OECD's discussion draft - clarification of the meaning of "beneficial owner" in the OECD Model Tax Convention

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the OECD's discussion draft. AFME represents a broad array of European and global participants in the wholesale financial markets, and its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants.

Introductory comments

The discussion draft states that the purpose of the proposed changes is to clarify the interpretation of the concept of "beneficial owner". We welcome the objective of clarification and we consider that it is critical to get the changes right, given the importance of the OECD Model Tax Convention and the Model Commentary to the interpretation of treaties between OECD member countries, and the influence of the Model Commentary in interpretation of treaties by non-OECD member countries.

We believe the OECD has a vital role in promoting cross border investment. We are concerned, however, that the proposed changes may themselves be capable of being interpreted in different ways. So, whilst we acknowledge that the changes are intended to clarify the position, we consider that in practice the changes are likely to introduce further uncertainty and therefore to have an adverse effect on cross-border investment.

We set out below some initial thoughts on the discussion draft, and would be pleased to contribute further as the OECD's work progresses and as our members' thinking develops in light of industry discussions.

Proposed definition

We note the proposed definition at new paragraph 10.2 to the effect that "The recipient of an interest payment is the "beneficial owner" of that interest where he has the full right to use and enjoy the interest unconstrained by a contractual or legal obligation to pass the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the full right to use and enjoy the interest".

We are concerned that the guidance is capable of varied interpretation, thus compromising the clarity that the discussion draft aims to provide. In order to ensure consistent interpretation, we believe that the proposal should be accompanied by examples illustrating intent (which may be supplemented over time as new points of potential disagreement arise).

The role of banks and other financial institutions

In order to put the examples into context, we would note that banks and other financial institutions perform a critical role in the functioning of economies, helping businesses, Governments and other bodies raise finance and providing opportunities for investors. In the course of these activities, banks become owners for their own account of the full range of products, ranging from loans through publicly traded debt and equity securities. They will be fully exposed to all the risks that ownership brings.

Good governance demands proper management of risk and therefore banks may hedge their risks, either fully or in part. Managing risk therefore means that banks will not economically fully benefit or suffer from the relevant risk. We do find the draft guidance troubling in this respect, in the sense that, if the guidance were to be read without a detailed appreciation of the way that banks operate, it might be inferred that sound risk management practices could compromise beneficial ownership.

There are ongoing reforms to the regulatory environment which are designed to improve the stability of the financial system and to promote responsible lending and management of risk. The OECD should seek to avoid taking steps which could result in encouraging fiscal barriers to these objectives.

Examples

We set out below some stylised examples which may help to illustrate what we believe to be the correct interpretation of beneficial ownership in certain common situations.

We would stress that there are many other examples that we could provide to illustrate the same point. We hope it is clear that our choice of examples is not intended to imply that other examples are in some way less relevant or important. However, we believe that the examples we have chosen provide a good indication of some of the difficulties that the guidance presents due to its reference to "facts and circumstances" without any clarification.

Example One (loan to a customer, financed by a combination of debt and equity)

Suppose that a lender advances a loan to a customer, and that the customer pays interest to the lender.

The lender will have financed the loan by way of debt and equity, and will have an obligation to make payments of interest to the debt holders. By such borrowing the lender may hedge or reduce their interest rate risk on the loan. For example, payments of interest to the debt holder might be the same, or very similar, to the payments received from the borrower.

The lender is not acting in an agency, nominee or mere fiduciary capacity, and the lender would be the beneficial owner of the interest income received from the borrower, notwithstanding that the lender is required to make payments to another person.

Example Two (loan to a customer, and hedging credit risk with a credit derivative)

Suppose that a lender advances a loan to a customer, and that at some time during the period of ownership, the lender wishes to reduce the credit risk it is taking. The lender could achieve this in various ways. For example, it could enter into a credit derivative with another person (the derivative counterparty). Such a credit derivative could include terms providing that:

- the lender makes periodic payments to the derivative counterparty
- in the event that the borrower fails to make payments of interest and/or principal to the lender, the derivative counterparty makes compensating payments to the lender.

In this example, the lender is not acting in an agency, nominee or mere fiduciary capacity, and the lender would be the beneficial owner of the interest income received from the borrower, notwithstanding that the lender is required to make payments to another person.

For completeness, we would note that in reality a bank may take hedging decisions on a portfolio basis (for example, in relation to a portfolio of loans and debt securities) and that a bank may enter into a credit derivative without having ownership of the underlying loans or debt securities.

Interaction with anti-avoidance provisions

We would note that the conclusion that the lender is the beneficial owner in any particular circumstances does not oblige the contracting state to give treaty benefits.

Contracting states still have the protection of anti-avoidance provisions (such as limitation on benefits) which are designed to counter abuse of treaties, and we consider that in order to clarify the interpretation of treaties, any concerns regarding avoidance should be dealt with under these provisions.

We are concerned that the proposed changes would in practice effectively turn the beneficial owner condition into a broad anti-avoidance provision, rather than one focused on agent or nominee situations, leading to inconsistent interpretation of a fundamental point, which would generate uncertainty thereby undermining the purpose of treaties.

We consider that greater certainty and predictability would be achieved by making a clear distinction between the beneficial ownership definition and the conditions under which the anti-avoidance provisions may apply.

Conclusion

For the reasons set out above, we would ask the Working Party to consider including examples of this kind in the commentary, in order that the concept of beneficial owner can be consistently interpreted. We would also ask that the Working Party take into consideration that interest, dividends and royalties play a particular role in financial services (i.e. they are typically trading items) and thus have a different character from such items in the context of other owners. We would be very pleased to develop the examples further if that would be helpful, and more generally we would of course be available to discuss any aspect of the consultation as needed.

We participated for several years in previous OECD consultations that were focused on banking, notably the OECD discussion draft on the attribution of profits to permanent establishments and the Banking Study. We are also aware of the ongoing work with regard to the treaty entitlement of collective investment vehicles as well as the work on the enhanced relief mechanism for cross-border investments (Implementation Package and Trace project). The current proposals are of course of wider application and we consider them as crucial for certainty in financial markets and for the financial industry. We believe that the proposed changes should not be included in the Commentary to the OECD Model Tax Convention in the present format without further addressing the additional issues which we have tried to illustrate (without being exhaustive).

We urge the OECD to consider whether it would not be of substantive benefit to further discuss these matters in some joint meetings between representatives of Working Party 1 and representatives of the financial industry, and potentially other interested parties/stakeholders. We would very much welcome such an opportunity for further participation in relation to the current proposals.

Yours sincerely

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