Comments received on Public Discussion drafts

# BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

7 May 2014

OECD
BETTER POLICIES FOR BETTER LIVES

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1 May 2014

Dear Sirs,

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

The Alternative Investment Management Association[1] wishes to comment on four of the proposals set out in the OECD discussion draft on BEPS Action 2.

AIMA is concerned that certain aspects of the measures recommended in the Discussion Draft will, if adopted in their present form, have significant effects on the ability of collective investment schemes in general (and not limited to those in the alternative investment sector which AIMA represents) to make and manage investments at a time when many economies are looking to sources of finance outside the banking sector. The asset management industry globally now accounts for some $64 trillion assets under management.

The measures in our view have been drawn up with the activities of multinational corporations in mind and without sufficient consideration for their potential effect on investment funds as providers of capital[2].

**Prospective Application – Question 5.2 Page 79**

Investment funds pool investors' capital to enable their investment into a range of underlying asset classes and are an important source of cross-border investment capital. Company law and tax law differ both in form and interpretation from country to country. Alternative investment funds invest in asset classes that have different risk and liquidity profiles compared to listed shares and debt. As a result, their investments are often made with the intention of long term capital growth and there is a more limited market to exit which also makes restructuring existing arrangements challenging. AIMA believes that it is important for the certainty that taxpayers and capital markets require that any tax changes are prospective in application and there is grandfathering of existing arrangements and transactions which are compliant with existing tax laws.

In response to Question 5.2 on Page 79 of the Discussion Draft "Are there further technical recommendations that should be addressed in the final report?", AIMA requests that there is grandfathering in all jurisdictions of existing arrangements and transactions.

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, funds of hedge fund managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in over 50 countries.

[2] It should be noted that an investment fund is a corporation or partnership owned by investors whose assets are managed by an investment manager on a discretionary basis. The investment fund, its investments, the investors and the investment manager will very often be located in different jurisdictions and subject to different tax regimes.

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**Scope of Hybrid Financial Instrument Rule – Paragraphs 118-124**

The Discussion Draft outlines two approaches to defining the scope of the hybrid financial instrument rule: defining what is included (a "bottom-up" approach) or defining what is excluded (a "top-down" approach).

An investment fund which invests internationally will have multiple local tax compliance obligations. It is critically important to investors and investment funds when making international investments that certainty can be achieved in taxation treatment at the time of making the investment. In addition, an investment fund cannot distribute returns to investors to the extent it needs to retain provisions for uncertain tax positions.

AIMA believes that there should not be barriers imposed to international investment by uncertain tax legislation and implementation and that tax legislation should be as clear and targeted as possible. Accordingly, AIMA expresses its support for a "bottom-up" approach.

**Related Parties – Paragraphs 126-130**

AIMA believes that the 10% or greater ownership threshold is too low for a party to have sufficient knowledge or information about its counterparty's tax treatment. Without a commercial override in the proposed structure of the rules, the 10% related party test could catch many ordinary commercial transactions. For example, in the context of an investment fund which is widely held and open-ended, an investor could move through the 10% threshold without any action of its own (e.g. if another investor redeemed). AIMA believes that the ownership threshold should be set at a level at which a party has the ability to control the structure of the transaction.

In addition, the proposed definition of "acting in concert" would appear to catch many investors in investment funds structured as limited partnerships and contractual funds without any percentage ownership requirement. AIMA would support an exemption for investors in investment funds structured as limited partnerships or contractual funds where the investors do not have the ability to control the vehicle.

**Comprehensive Hybrid Mismatch Rules & Reporting – Paragraphs 218-236**

The Discussion Draft refers to new filing and information reporting requirements for entities which are "intermediaries". In addition, the Discussion Draft refers to a possible approach of deeming an intermediary to be resident in an investor jurisdiction where an intermediary is part of the same group (50% or more) as an investor.

The asset management industry has significant experience in implementing existing tax reporting requirements and providing the tax reporting that investors require for numerous local jurisdictions. It is currently working to comply with the introduction of FATCA, the revised EU Savings Directive and other AEOI measures.

Taking into consideration the different circumstances that apply to investment funds, compared with multinational corporations, AIMA would support the creation of a dedicated specialist working group to assess these suggested requirements for intermediaries to the extent they should be applied to investment funds. AIMA would be pleased to work with the OECD in sharing existing experience on investor tax reporting requirements that investment funds provide to investors and, if required, the development of a common standard for these matters.

Yours faithfully,

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2 May 2014

**By email to: aggressivetaxplanning@oecd.org**

Dear Sir,

## Discussion draft on neutralising the effects of hybrid mismatch arrangements

AFME[1] and the BBA[2] welcome the opportunity to respond to the OECD's discussion draft entitled "BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements" published on 19 March 2014 (the **discussion draft**). We wish to make clear that while AFME and the BBA have separate and distinct memberships, for the purposes of the OECD discussion draft, both organisations have decided to submit a single, combined response since our respective members share some concerns with the OECD's proposals in the discussion draft.

## General Comments

We welcome that the OECD is consulting with business on its proposals. We believe that this approach is to the benefit of both policymakers and business and helps to avoid any unintended consequences arising from the OECD's proposals. We believe that it is also valuable for the OECD to take account of the views of business on the practical aspects of operating the intended policy.

[1] The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

[2] The British Bankers' Association (BBA) is the leading association for the UK banking and financial services sector, speaking for 180 banking members, headquartered in 50 jurisdictions and operating in over 180 territories worldwide jurisdictions, on the full range of UK or international banking issues. Collectively providing the full range of services, our member banks make up the world's largest international banking centre.

Given the relatively short time available it has been hard to consider all aspects of the discussion draft and we are therefore providing specific comments on some of the most important issues of concern to us. We may write to you again with further comments once we have had a chance to consider the proposals in greater detail.

**"Bottom-up" v "top-down" approach**

We note that paragraphs 119 and 120 of the discussion draft set out two possible approaches to defining the scope of the hybrid financial instrument rule: a "bottom-up" approach - where the arrangements (specifically related party transactions and "structured" transactions) that are to be covered by the proposed anti-hybrid rules are defined - or a "top-down" approach - where there is a broad rule that applies to all hybrid mismatches other than those that fall within certain defined exceptions where it would be impossible or unduly burdensome for the taxpayer to comply with the rule.

We believe that a bottom-up approach would be preferable to a top-down approach. We are concerned that the latter runs the risk of being overly broad, may create unintended consequences, and may capture ordinary lending arrangements that present little risk from a hybrid mismatch perspective. We note also that a top-down approach could introduce the compliance concerns and information reporting requirements set out in paragraphs 142 to 144 of the discussion draft.

We note in paragraphs 146 to 157 of the discussion draft, the suggested exemption from the anti-hybrid rule for "widely-held" instruments. We note that paragraphs 150 to 152 of the discussion draft discuss whether the exemption for widely-held instruments should be limited to issuers so that holders would still be required to include a deductible payment in income even if the issuer benefitted from the widely-held exemption. Paragraph 152 of the discussion draft notes that such an approach would require a mechanism that allowed the issuer to communicate information to the holder about the tax treatment of the instrument involved and the holder would likely have to obtain tax advice on differences between foreign and domestic treatment in order to comply with the hybrid mismatch rule. As the discussion draft acknowledges, such an approach may be costly and resource intensive and would be imposed on all instruments regardless of whether they contained a hybrid element. We believe those deficiencies would indeed arise, and are therefore concerned that such an approach could limit the depth of the primary markets and reduce liquidity in the secondary markets.

We note that paragraph 157 of the discussion draft suggests that any exception for traded instruments would need to be limited so as to exclude those cases where the transfer is to a related party or the transfer is part of structured arrangements designed to engineer a hybrid mismatch. If the OECD does decide to proceed with a top-down

approach, we note that such an approach would need to be carefully addressed with respect to related party underwriters and related party market makers.

In summary, we think that there are fundamental problems with a top-down approach, which will lead to unintended effects on cross-border business that is not tax motivated and result in an impractical compliance burden.

**Further comments on the bottom-up approach**

Whilst we believe that a bottom-up approach is preferable to a top-down approach, we also note that the bottom-up approach in the form proposed by the OECD would require the hybrid financial instrument rule to apply to all instruments held between related parties (including persons acting in concert). We do not think that that is a properly targeted measure.

First, as the discussion draft sets out, the intended target is tax motivated arrangements. Accordingly, we do not agree that it is appropriate to have a rule which proceeds on the basis that all related party transactions are potentially subject to counteraction under the BEPS hybrids rules. This would mean that a local subsidiary of a foreign group would be disadvantaged when compared to domestic competitors in the same market. We therefore consider that the bottom-up approach needs to better target tax motivated arrangements, rather than proceeding on the basis that all related party transactions giving rise to a mismatch need to have their tax treatment adjusted.

Second, paragraph 128 of the discussion draft proposes a 10% ownership test to define related persons. We are concerned that such an ownership threshold is far too low and may catch transactions that present no risk from a hybrid mismatch perspective. A threshold at that level also presents a number of practical problems. We suggest that the OECD considers using a greater than 50% ownership requirement, augmented by a rule that deals with parties acting in concert, which should be much better targeted at cases of potential concern.

Measures may also be needed to cover takeover situations, and any other cases where a third party independently acquires a stake in another company or group, which suddenly makes it related for the purposes of a hybrids rule. This is a general point, but may be particularly relevant to banks, which may issue a wide range of securities to third party investors in the ordinary course of business. For example, it would be normal business for many banks to issue asset linked notes. These are instruments that allow investors to gain financial exposure to an underlying asset, such as movements in the value of an index of shares. The tax characterisation of such instruments might be different in different jurisdictions. If a third party holder of such an instrument (or any other hybrid) subsequently makes a substantial investment in the shares of that banking group, that investor may become a related party. The approach outlined in the discussion draft suggests that the tax treatment of the asset linked note would then

need to be adjusted, which it would not have been prior to the investor acquiring the shares in the bank.

It is instructive to consider the above example where the order of events is reversed, i.e., the starting point is that the investor already holds sufficient shares in the banking group to be a related party, and then wishes to make an investment in a note with a return linked to the performance of a national index of shares. In that case, the OECD's proposed approach would mean that the bank (bank 1) knows, before it issues the asset linked note, that the hybrids rule will counteract its local tax deduction for payments under the asset linked note (again assuming the investor does not have a matching tax treatment on the income). This means that bank 1's cost of issuing that asset linked note is substantially higher than the cost to a domestic competitor bank (bank 2), if bank 2 is not related to the investor, such that bank 1 cannot properly compete with bank 2. This illustrates the general point: a rule which adjusts the treatment of all related party hybrids is too broad as it distorts competition where there is no policy need to deny a tax deduction.

**Hybrid regulatory capital**

The level of capital which banks are required to hold is currently subject to extensive and developing regulatory rules designed to ensure the stability of banks and the wider financial system. This includes Basel 3 which sets a requirement that financial institutions hold minimum levels of capital with the aim of ensuring that banks have sufficient regulatory capital to continue operations throughout times of economic and financial stress. In particular, banks are required to hold 6% of their risk weighted assets in the form of Tier 1 capital, of which 1.5% may be met with Additional Tier 1 instruments (**AT1**). AT1 instruments provide an important and readily available source of capital in times of financial crisis. Such instruments have both equity and debt like characteristics and many countries have determined or are in the process of determining which treatment should follow for tax purposes. Accordingly, certain forms of cross-border regulatory capital could be considered as hybrid instruments for the purposes of Action 2 of the OECD Action Plan on BEPS. We believe that it is important that any recommendations made by the OECD in relation to Action 2 do not undermine the regulatory regime which is designed to ensure that banks are able to raise adequate regulatory capital.

An additional concern with regard to the treatment of regulatory capital as hybrid instruments would be any presumption that all forms of hybrid capital should be subject to increased scrutiny. We believe that any anti-avoidance provisions aimed at hybrid instruments should be limited to specific instruments where there is a justified concern over the use of the instrument. A bottom-up approach more properly focussed on tax motivated transactions should remove the need for any special rules for regulatory capital.

As noted in paragraph 160 of the discussion draft, as part of a wider move towards "single point of entry" resolution, a number of regulators are encouraging banks domiciled in their jurisdiction to issue all their loss absorbing capital at top holding company level and then pass this capital down through the group to the relevant operating subsidiaries. As further noted in paragraph 160 of the discussion draft, such arrangements of intra-group capital may also be motivated by the fact that regulatory capital issued directly to the market at subsidiary level may, in certain situations, be discounted or disregarded for consolidated regulatory capital purposes. As such, special consideration needs to be given to the ability of banks to issue such instruments within a group. Inconsistent treatment of intra-group regulatory capital and capital issued to the market would create tax distortions in a financial institution's consolidated regulatory capital, and financial institutions operating under a single point of entry funding model would be placed at a competitive disadvantage relative to groups issuing directly to the market at the subsidiary level. As we have noted already in our general remarks, such an inconsistent treatment would also place inward investing groups at a competitive disadvantage relative to domestic institutions. We therefore welcome the inclusion in the discussion draft of paragraphs 158 to 162 and in particular the suggestion that consideration should be given to the inclusion of a co-ordination rule which would allow the tax effect of the issuer's deduction to be passed down through chains of related parties to the ultimate borrower. We are in the process of considering how a co-ordination rule might operate in practice and we may write to the OECD again in due course with further specific proposals. We are concerned to ensure that any proposals are appropriate for all stakeholders and do not have any unintended consequences for banks and tax authorities. For the avoidance of doubt, the approach we would advocate (a better targeted bottom up approach) would mean that allocation rules or co-ordination rules would not be required.

**Repo transactions**

We note that paragraphs 65 to 80 and 262 to 270 of the discussion draft set out that hybrid transfers are typically a particular type of collateralised loan agreement or derivative transaction where the counterparties to the same arrangement in different jurisdictions both treat themselves as the owner of the loan collateral or subject matter of the derivative. We are concerned that the examples provided of hybrid transfers involving sale and repurchase transactions (repos) may appear to give the impression that repo transactions are only used for tax planning purposes. For example, we note that paragraph 66 of the discussion draft states that "the most common transaction used to achieve a mismatch in tax outcomes under a hybrid transfer is a sale and repurchase arrangement…over an asset where the terms of the repo make it the economic equivalent to a collateralised loan."

Repos are entered into in the ordinary course of business on a daily basis by financial institutions for commercial purposes which are not motivated by tax reasons. We

therefore believe that any recommendations involving repos should make clear that they are not within the scope of the anti-hybrid rules unless they are part of a structured hybrid mismatch arrangement.

Finally, we are grateful for the opportunity to share our comments with the OECD on the discussion draft and we would be happy to discuss any of the above comments in greater detail.

Yours faithfully,

**Richard Middleton**
**Managing Director, Tax and Accounting Policy**
**AFME**

**Sarah Wulff-Cochrane**
**Director of Policy**
**BBA**

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Yours faithfully,

**Richard Middleton**
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Association of British Insurers

**Design of Hybrid Mismatch Rules**

## The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

## The ABI

The Association of British Insurers (ABI) is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

• Be the voice of the UK insurance industry, leading debate and speaking up for insurers.

• Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.

• Advocate high standards of customer service within the industry and provide useful information to the public about insurance.

• Promote the benefits of insurance to the government, regulators, policy makers and the public.

## General comments

The ABI supports the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment. We therefore support the objectives of the discussion draft[1] in combating aggressive tax planning aimed at situations where instruments (or entities) are taxed on different bases between territories with tax advantageous results. Our comments reflect our desire to ensure that any measures are workable, well targeted, and proportionate in the context of the efficiency of commercial insurance operations. In the spirit of working constructively with the OECD and member governments, we offer information and suggestions as to how proposals could be improved to help achieve objectives whilst at the same time avoiding inadvertent consequences impacting on the normal conduct of insurance business models.

[1] The first discussion draft on Action 2 (Neutralise the effects of hybrid mismatch arrangements) of the BEPS Action Plan issued by the OECD on 19 March 2014.

It should be borne in mind in reaching any conclusions on neutralising the effects of hybrids mismatch arrangements that there are other BEPS actions which may impact on the conclusions. In particular, Action 4 (Limit Base Erosion via Interest Deductions) has a read across to tax deductibility of payments on hybrid financial instruments. So the ABI recommend that any conclusions reached to neutralise the effects of hybrids mismatch arrangements should be initial/provisional conclusions which can be finalised when the outcome of all BEPS actions is known.

**Summary of the ABI response**

**General**

For the insurance sector regulatory hybrid capital is essential for regulatory and commercial reasons (including obtaining a lower cost of capital from issuing debt rather than equity) as insurance companies use these instruments to meet their regulatory solvency and capital adequacy requirements. We explain in Appendix 1 how regulatory hybrid capital fits into the regulatory framework of insurers.

Our response focuses on the potential impact of the proposals contained in the discussion draft on the regulatory hybrid capital of insurers. Regulatory hybrid capital of insurers is not designed to create tax mismatches and therefore its use does not constitute a harmful tax practice. Its hybrid nature derives from the need to introduce some loss absorbent features to enable debt to meet requirements of regulators.

Insurers' regulatory hybrid capital is commercially regarded as debt, rated as such by rating agencies and listed on the bond markets. Furthermore a number of tax authorities in the EU generally treat regulatory hybrid capital as debt. So, in most cases there is in fact no tax mismatch.

**Regulatory hybrid capital of insurers**

An issue of regulatory hybrid capital by an insurer to the market to wholly unrelated parties would, even in the most straightforward situations, create significant difficulties in identifying the holders for the following reasons:

- There is no requirement for insurers to hold a register of the owners of regulatory hybrid capital.
- For each issue of regulatory hybrid capital by an insurer there would normally be a large number of holders.
- Regulatory hybrid capital of insurers is often held through custodian accounts or through agents.
- Insurers' regulatory hybrid capital is freely traded and therefore the holdings will change hands.

The discussion draft suggests that the two approaches being considered to define the scope of the hybrid financial instrument rule are "bottom up" or "top down". However, as explained in detail in our response to question 4 and 6, in addition to the difficulties above, the current proposed definition

of related party will mean whichever of these approaches is used it would in most cases be practically impossible for insurers to identify the holders of their externally issued regulatory hybrid capital.

In light of this, the ABI's view is that regulatory hybrid capital issued by insurers to the market and listed on an exchange should be carved out from the hybrid financial instrument rule. Such an exclusion should not give rise to the use of such instruments to create tax mismatches as the amount and form of an insurers' capital that obtains credit for regulatory capital purposes is subject to limits (as outlined in Appendix 1). In addition, the sub-ordinated nature of such instruments mean that the finance costs associated with the instruments are higher than other debt instruments and therefore such instruments would only be issued where they are expected to be counted towards an insurers' regulatory capital. This proposed carve out could be drafted to ensure that it would not apply if there are structured arrangements if there are concerns around avoidance.

Carving out regulatory hybrid capital issued to the market and listed on an exchange would not carve out regulatory hybrid capital issued by private placement or issued intra group. Both of these types of issue involve a different issue mechanism, but they have the same effect; namely an issue for regulatory purposes to obtain hybrid regulatory capital that meets regulatory requirements of having loss absorbent characteristics. With private placement there would also be difficulties, which are explained in our response to questions 4 and 6, in identifying holders of an insurers' regulatory hybrid capital. In view of the identification issues with private placements, the fact that they are issued externally and are undertaken for regulatory purposes, the ABI believe that any external regulatory hybrid capital that is not carved out because it is issued to the market and listed on an exchange should also be carved out from the hybrid financial instrument rule provided it is "tradeable". In addition, we believe there should be parity for intra group issues for the reasons explained in our response to question 8(c). These proposed carve outs could be drafted to ensure that it would not apply if there are structured arrangements if there are concerns around avoidance.

There would need to be a definition of regulatory hybrid capital to ensure that only that capital issued for regulatory purposes would qualify to be carved out. The definition used could be closely linked to the regulatory definitions for banks and insurers respectively.

If a carve out of regulatory hybrid capital is not possible then the ABI's strong preference is for a "bottom up" approach as it better focused. Although there would still be significant identification difficulties with a "bottom up" approach these can be overcome if the current proposed 10% holding to be a related party was increased to a more appropriate level to reflect the fact that insurers often have portfolio holdings of more than 10% - in view of the identification issues and depending on the related party holding limit there may need to be a presumption that, unless there was evidence to the contrary, external issues are not held by related parties. If the related party limit was at a controlling interest level then it is highly unlikely an insurer would have any difficulties in identifying related parties. The ABI acknowledge that some jurisdictions may regard controlling interest as being too high a level of holding. Concern about this could perhaps be reduced if the higher limit was applicable only to regulated banks and insurers. It could also be subject to a purpose test if further protection were needed.

An alternative approach in identifying whether there is a related party would be to consider whether GAAP consolidation is required. The benefit of this is that it would be based upon objective tests that

groups have to apply in drawing up their statutory accounts. It would also ensure that the rule is targeted at situations where there is genuine (and purposeful) economic connectivity between the parties. We believe that this addresses the situations set out in paragraph 128 of the discussion draft. Taking IFRS 10 ("Consolidated Financial Statements") as an example the key principals are that that control exists, and consolidation is required, only if the investor has *power over the investee, exposure to variable returns from its involvement with the investee* and *the ability to use its power over the investee to affect its returns*. There should be a reassessment if facts and circumstances indicate changes to any of these elements.

A further alternative is to use the beneficial owner limit for corporate entities in the proposed EU Fourth Anti-Money Laundering Directive. The proposed Fourth Directive defines[2] this for corporate entities, as the person who "owns or controls a legal entity through direct or indirect ownership or control over a sufficient percentage of the shares or voting rights." This is the same definition as is in EU third Anti-Money Laundering Directive and it is understood that this level of control also applies for FATCA.

The "top down" approach is widely drawn and therefore fraught with practical difficulties in how to avoid catching innocent commercial transactions. In particular, as explained in the response to questions 4 and 6, the ABI's view is that "widely held" and "traded" carve outs would not exclude all external issues of regulatory hybrid capital of insurers. As such, a "top down" approach would mean that in most cases it would be practically impossible for an insurer to identify holders of its externally issued regulatory hybrid capital.

The ABI's view is that, as regulatory hybrid capital of insurers is not designed to create a tax mismatch, whether a "bottom up" or a "top down" approach is used, all issued regulatory hybrid capital should be excluded from the hybrid financial instrument rule unless structured arrangements are involved. If such capital is not excluded, the current proposals have the potential to impact capital markets, increase the cost of capital for insurers, the competitiveness of the insurance sector and ultimately the price charged to consumers.

Regulatory hybrid capital has to be long term given its nature and original purpose. The Lender has no rights or only rights on maturity to force repayment and the borrower is entitled to repay at certain dates, usually at least 5 or 10 years after initial issuance. Hence, it is difficult, costly to unwind and the timing of any unwind will be dependent on market conditions. As such, any change in the laws which impacts on the hybrid nature of regulatory hybrid capital should include appropriate transition rules for existing issues. The ABI suggests that if insurers' regulated hybrid capital is not carved out then any new hybrid rules that impact on insurers' regulated hybrid capital should be prospective and existing issues should be grandfathered.

**Insurers as investors**

Life insurers invest the premiums received from policyholders in a broad range of instruments. With a "top down" approach it would be a significant and unreasonable compliance burden to expect insurers to review all their investments and to identify the tax treatment in the issuers' jurisdiction(s). This is particularly so as the scope of "instruments" covered by the proposed rules is very broad. However,

[2] Article 3 (5) of the proposed EU Fourth Anti-Money Laundering Directive

with a "bottom up" approach there would not be the same problems provided that the related party limit was increased to a more appropriate level to ensure insurers' portfolio holdings do not come within the related party definition.

There would be a further problem where the profits and gains of a particular class of insurance business are exempt from tax. As stated above life insurers invest in a broad range of instruments for commercial investment purposes to support policyholder liabilities (e.g. the long dated nature of these assets can match against the long dated nature of those policyholder liabilities). Some of these investments may be in hybrid instruments. If the investments support an insurers' pensions business, where income and gains from portfolio holdings are exempt from tax, the requirement to identify the relevant instruments and the "ordinary income" places a disproportionate and unnecessary compliance burden on life insurers. The ABI therefore suggests that for the avoidance of doubt there should be no requirement to identify the "ordinary income" where hybrid instruments are held to support pension business or other business of life insurers where in practicable terms the income of that business is exempt from tax. Failure to do this might result in life insurers ceasing to make such investments, because of concerns around tax compliance failures, which may result in a negative impact on capital markets.

**Other points**

On a general point the ABI believe that for the hybrid financial instrument rule to work it is essential that it is introduced consistently at the same time in all jurisdictions**.** If not introduced consistently and at the same time it will raise competition issues and disadvantage insurance operations in countries where the rule is adopted.

**Responses to specific questions**

***1. Are the objectives and design principles of the hybrid mismatch arrangements clear?***

Yes. The automatic application of the rules, aiming to keep things simple, means that the test is objective and no account is taken of whether there is a tax avoidance purpose. Whilst the ABI understands the desire for objective rules, we are concerned that this will increase the likelihood that transactions not currently foreseen could be caught inadvertently. This is particularly so as the scope of "instruments" covered by the proposed rules is very broad which would bring in a number of instruments, especially with the "top down" approach.

If the design has to be automatic, then it is extremely important the exclusions remove the largest amount of commercial arrangements as possible to minimise complexity/double taxation, compliance costs, etc. For the insurance industry a major concern is that complying with the proposed hybrid financial instrument rule could result in increased costs of capital at a time when capital requirements are already becoming more stringent under Solvency II.

***2. If further clarification is required, then where is this required and how could it best be provided?***

The Table on page 18 does not detail the full scope for hybrid instruments – as our later comments highlight this is of critical importance to insurers. As explained later in this response we believe that both external and intra group regulatory hybrid capital should be excluded from the scope of these rules.

**2. Hybrid Financial Instruments & Transfers**

***1. Is it clear what elements need to be present in order for the rules neutralising hybrid financial instruments or hybrid transfers to apply?***

Yes. The rules only apply where the mismatch is a product of the hybrid element of the financial arrangement.

***2. Is the outcome of the rules' operation clear?***

Generally yes. The description of the application of the rule in paragraphs 109 and 110 helps with the understanding. However there may be a risk that particular jurisdictions could act unilaterally with the result that there will be taxability in one jurisdiction and no relief in the other, i.e., in the example in paragraphs 109 and 110 Country A would deny the domestic dividend exemption and Country B might also deny relief for the payment. It is therefore important that tax authorities introduce domestic legislation that is consistent and that there is a mechanism in place to deal with situations where there is taxability in one jurisdiction and no relief in the other – it is as important to avoid double taxation as double non-taxation. Where there is double taxation and there is a double taxation treaty then that should be the mechanism, but there would need to be timely and effective MAP procedures. There is therefore a link here to BEPS Action 14. There also needs to be a mechanism to arbitrate where there is no treaty.

***3. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?***

The ABI is unaware of any arrangements which should be caught by the rules but are not addressed in the recommendations.

***4. This document sets out two possible approaches to drafting a scoping rule and summarises the possible advantages and disadvantages. Are the advantages and disadvantages accurately describe and are there any other advantages and disadvantages of the two approaches?***

***(a) What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration?***

***6. What definition could be used to capture the concept of "widely-held" or regularly "traded" whilst also addressing concerns that any exemption should not be available to related parties, parties acting in concert or parties to a structured arrangement (i.e. an arrangement designed to***

***obtain the benefit of a mismatch).***

The description of advantages and disadvantages of the two approaches appears to be accurate and complete.

In outlining our response to questions 4 and 6 we are commenting in the context of externally issued regulated hybrid capital by insurers. Our response on internally issued regulatory hybrid capital by insurers is covered in our response to question 8 below.

Even with a straightforward issue of regulatory hybrid capital by an insurer to the market to wholly unrelated parties there would be significant difficulties in an insurer identifying the holders for the following reasons:

- There is no requirement for insurers to hold a register of the owners of regulatory hybrid capital.
- For each issue of regulatory hybrid capital by an insurer there would normally be a large number of holders.
- Regulatory hybrid capital of insurers is often held through custodian accounts nominees, or agents.
- Insurers' regulatory hybrid capital is freely traded and therefore the holdings will change hands.

The discussion draft at paragraph 127 suggests that non-portfolio holdings should be defined as holdings greater than 10%. It is not unusual for life insurance companies to have what are properly regarded as portfolio holdings where the percentage of the share capital held (or the interest held via an investment fund) exceeds 10%. This is because a life insurer receives substantial premiums from policyholders which it invests to support policyholder liabilities. As a result portfolio holdings of a life insurer may exceed a 10% holding. In view of this even with a "bottom up" approach the proposed definition of related party will catch some portfolio holdings of life insurers. As a result a life insurer will have to identify whether any of its portfolio holdings of more than 10% have themselves invested in their regulatory hybrid capital. This will cause a significant and disproportionate compliance burden.

There will also be some situations where an insurance company, even one that is quoted, has shareholders with more than a 10% holding. The low related party test threshold of 10% is therefore likely to mean that there will be investors in externally issued regulatory hybrid capital of insurers who meet the criteria to be a related party for these purposes. In these situations the insurer would, as explained below, have difficulty in identifying holders of their regulatory hybrid capital and would not have any information about the tax position of the holders. The two examples below help explain the issue further:

- Insurer A as part of its normal investment activities invests in 11% of the share capital of Bank B. Subsequent to that investment Insurer A issues regulatory hybrid capital to the market some of which is acquired by Bank B. In these circumstances Insurer A and Bank B would be related parties and Insurer A would need to consider whether the hybrid financial instrument rule applies.

- Bank B invests in 11% of the share capital of Insurer A. Subsequent to that investment Insurer A issues regulatory hybrid capital to the market some of which is acquired by Bank B. In these circumstances Insurer A and Bank B would be related parties and Insurer A would need to consider whether the hybrid financial instrument rule applies.

In both the examples above there would be the following identification difficulties for Insurer A:

1. There is no requirement to hold a register of the owners of the externally issued regulatory hybrid capital. There is therefore no comprehensive record of the current holders of regulatory hybrid capital. Furthermore, regulatory hybrid capital is usually held through custodian accounts, nominees or other agents etc. So, in most cases it would be practically impossible for Insurer A to know the identity of holders of its regulatory hybrid capital (which may well change from day to day) and whether any of the holders were related parties.

2. Even if Insurer A knew that Bank B acquired its regulatory hybrid capital on issue, it would not know whether Bank B still held it, i.e., Bank B may sell the regulatory hybrid capital and the identity of the purchaser may not be known, particularly if the regulatory hybrid capital is held through custodian accounts, nominees agents etc.

3. The level of shareholdings is likely to change over time, which would mean that Insurer A would be required to continually monitor who owns its shares, directly and indirectly, as well as who owns its regulatory hybrid capital. Even if this were feasible, which is unlikely, it would be a disproportionate administrative burden for instruments where the hybrid elements are required by the regulator and are not designed to create a tax mismatch.

4. Insurer A would need to continually monitor its investments to identify whether it held more that 10% of any person. This would be an onerous task as it would also need to identify all investments (whether these were held directly, under stock loan or repo[3] agreements or held via investment funds) across the whole insurance group and amalgamate these to identify whether the related party limit is breached. Having identified any holdings where the related party limit is breached the insurer would need to see whether those related parties hold their regulatory hybrid capital. Even if this were feasible, which is unlikely, it would be a disproportionate administrative burden for instruments where the hybrid elements are required by the regulator and are not designed to create a tax mismatch.

From a practical point of view, if Insurer A could identify all related parties that hold its regulatory hybrid capital (which in most cases will be practically impossible) and the hybrid financial instrument rule applied then there would be the question of what amount of relief should be denied, i.e., the holder may not be a related party for all of the year or for all years. The amount of relief denied would therefore vary over time so creating uncertainty for insurers, impacting on their competiveness and give a result that is inappropriate.

A "top down" approach would create exactly the same problems identified in respect of related party holders (which is relevant to identify if the proposed "widely-held" and "traded" carve outs are dis-applied) of external regulatory hybrid capital as there are for the "bottom up" approach. In addition

[3] In both the stock lending and repo markets there is no compulsory reporting of transactions

there would also be the difficulties identified in paragraphs 147 and 148 of the discussion draft. It is therefore essential in order for the hybrid financial instrument rule to work properly that externally issued regulatory hybrid capital by insurers is carved out from the rule. The ABI does not believe the current proposed definitions of "widely-held" and "traded" are wide enough to ensure all externally issued regulatory hybrid capital of insurers would be carved out. We explain why this is the case below.

To make a hybrid financial instrument rule workable for issues of regulatory hybrid capital, the ABI's preference, under both "bottom up" and "top down" approaches, would be that all (both unrelated and related party) external regulatory hybrid capital issued by insurers is carved out from the rule, unless there are structured arrangements. This is because, as explained above, it will in most cases be practically impossible for insurers to identify all the holders of their externally issued regulated hybrid capital and the tax treatment in the holder's jurisdiction. The problems in identifying related parties are even more extreme when holdings via funds, repos, stock lending and similar instruments are taken into account.

If it is not possible for there to be a complete carve out for regulatory hybrid capital of insurers then we would strongly recommend that a "bottom up" approach is taken and:

- Only related party holdings are included
- The related party limit is set at a level that would not capture insurers' portfolio holdings. This would also have the benefit that it would exclude the vast majority of parties who are related simply because they have a minority shareholding in an insurer.
- In view of the identification issues and depending on the related party limit there may need to be a presumption that, unless there was evidence to the contrary, external issues are not held by related parties.

However, if a particular instrument is part of a structured arrangement then the hybrid financial instrument rule would apply.

If the above approach is taken it would again make the hybrid financial instrument rule workable for external issues of regulatory hybrid capital by insurers as it would carve out the majority, if not all, external issues of regulatory capital.

As regards the related party definition, the ABI believe that if the definition was that of a controlling interest then it is likely that an insurer would then be able to identify related parties and thus comply with the rules. The ABI acknowledge that some jurisdictions may regard controlling interest as being too high a level of holding. Concern about this could perhaps be reduced if the higher limit was applicable only to regulated banks and insurers. It could also be subject to a purpose test if further protection was needed.

An alternative to identifying whether there is a related party would be to consider whether GAAP consolidation is required. The benefit of this is that it would be based upon objective tests that groups have to apply in drawing up their statutory accounts. It would also ensure that the rule is targeted at situations where there is genuine (and purposeful) economic connectivity between the parties genuine. We believe that this addresses the situations set out in paragraph 128 of the discussion draft. Taking

IFRS 10 ("Consolidated Financial Statements") as an example the key principals are that that control exists, and consolidation is required, only if the investor has *power over the investee, exposure to variable returns from its involvement with the investee* and *the ability to use its power over the investee to affect its returns*. There should be a reassessment if facts and circumstances indicate changes to any of these elements.

The definitions of *ability to affect returns*, e*xposure to variable returns* and p*ower over the investee* are:

*Power over the investee* -

"existing rights that give the current ability to direct the relevant activities". The relevant activities are those that significantly affect the investee's returns, such as voting rights, appointment rights etc.

*Exposure to variable returns* -

Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee, e.g. dividends, management fees and returns not available to other investors.

*Ability to affect returns* -

This considers the interaction between the first two steps, namely whether the investor has the ability to use its power to affect the investor's returns from its involvement with the investee. The key consideration when assessing investment funds is whether the investor is a principal or agent. It is acting as principal that is important, i.e. acting on its own account and not that of another party. Consideration here is given to such as scope of authority, rights held by third parties and remuneration.

A further alternative is to use the beneficial owner limit for corporate entities in the proposed EU Fourth Anti-Money Laundering Directive. The proposed Fourth Directive defines[4] this for corporate entities, as the person who "owns or controls a legal entity through direct or indirect ownership or control over a sufficient percentage of the shares or voting rights." This is the same definition as is in EU third Anti-Money Laundering Directive and it is understood that this level of control also applies for FATCA.

If all issues of external regulatory hybrid capital by insurers are not carved out (either by a specific carve out for those instruments or by adopting a bottom up approach with a more appropriate related party limit) in addition to the identification issues, it could put insurers operating in countries where the rule is adopted at a competitive disadvantage impacting on their ability to raise this capital with the potential to impact on regulatory requirements. In particular, any denial of relief could raise concerns as a result of the impact on profits, capital and liquidity. It could also impact negatively on insurer's credit rating, share price and the general attractiveness of insurers' securities to investors. This would be reflected in an associated increase in the cost of capital potentially impacting on product pricing and/or analysts' profit models and valuations and ultimately costs to the customer.

[4] Article 3 (5) of the proposed EU Fourth Anti-Money Laundering Directive

The discussion draft at paragraph 160 assumes that Additional Tier 1 instruments (these have similar characteristics to regulatory hybrid capital of insurers) issued directly to the market are unlikely to be caught by a related-party hybrid mismatch rule or will be within specific carve out rules for "widely-held" or "traded". However we do not think this is necessarily the case.

We have explained why we believe that regulatory hybrid capital of insurers may be caught by the related party rule. Furthermore, as indicated above we do not believe the current proposals for "widely-held" and "traded regularly" would carve out all issues of external regulatory hybrid capital by insurers. This is because some external issues of regulatory hybrid capital by insurers are undertaken by private placement, a route which is simpler for insurers to raise capital. It also gives flexibility in the amount raised and tends to be used when smaller amounts of capital are required. The fact that private placement is used does not alter the commercial and regulatory environment of the issue of regulatory hybrid capital by insurers; namely, that the regulatory environment requires insurers to hold regulatory capital with high loss absorbency. So, although private placement involves a different issue mechanism, it has the same effect as a public issue (being obtaining hybrid regulatory capital that meets regulatory requirements of having loss absorbent characteristics). The insurer would have no control on any onward sale – for a successful issue the regulatory hybrid capital would have to be freely tradeable otherwise it would be prohibitively expensive. So it is not the case that a product has been structured to create a tax mismatch.

Even where there is an issue of regulatory hybrid capital by private placement there would still be difficulties with identification. In addition to the fact that they may be held through custodian accounts, nominees or through agents, they may be also sold to international investors via banks, which buy the bonds from the issuer and immediately sell them to investors. There is therefore often no direct link between the issuer and the holders. Another reason why the identity of the holder may not be known is where a fund buys the regulatory hybrid capital in their name, but then distributes them to other funds.

As stated above the issue of regulatory hybrid capital whether by public issue or private placement does not involve the structuring of a product to create a tax mismatch. However we understand that tax authorities might have concerns about this possibility. Therefore, any carve out of regulatory hybrid capital from the hybrid financial instruments rule, whether under "widely held" or a wider exemption for all regulatory hybrid capital, would only apply if there were no structured arrangements. i.e. the structured arrangement rule would take precedence over any carve out.

There could also be a priority rule to ensure the "widely held" and "traded/tradeable" regularly exemptions are not available to related parties and parties acting in concert.

We comment further on regulatory hybrid capital issued by insurers in our response to question 8 below.

***5. This part includes a number of examples: -***

***(a)What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties position?***

The answer to this question is covered in our response to questions 4, 6 and 8.

***(b) In this context are there any examples or situations that are more problematic than others? If so please explain why problems arise and what constraints or restrictions the parties might face in obtaining relevant information on the treatment of the counterparty?***

In the case of transactions such as repos and stock lending (both of which would need to be considered in identifying related parties), the market could be severely impacted with investors and issuers being faced with the choice of tax compliance failure or withdrawal from the market.

It is estimated that insurers comprise a significant part of the stock lending market of £1.1 Trillion[5]. As this market tends to involve high value and high frequency transactions with low margins, an insurer may decide to withdraw or reduced its participation in the market rather than risk a tax compliance failure. This could impact on the liquidity in the capital markets**.**

Insurers also play a part in the repo market. The size of the global repo market is estimated to be USD12 Trillion[6]. This market tends to involve high value and high frequency transactions with low margins and an insurer may decide to withdraw or reduced its participation in the market rather than risk a tax compliance failure. This could impact on the liquidity in the capital markets.

The ABI believes that in practice the proposals under 99-102 are unworkable for life insurers. A life insurer invests in a broad range on instruments, including hybrid instruments for commercial investment purposes to support policyholder liabilities. The aim of such investments is to get the highest gross return for policyholders. If the investments support pensions business, where income and gains are exempt from tax, paragraph 101 suggests that a life insurer would need to identify and to bring in otherwise untaxed income as taxable (if the hybrid financial Instrument rule applies) only to say it is not-taxable as it relates to pensions business. This would create a disproportionate and unnecessary compliance burden on life insurers in identifying the relevant instruments where in practical terms there are no tax implications as a holder. The ABI therefore suggests that for the avoidance of doubt there should be no requirement to identify the "ordinary income" where hybrid instruments are held to support pension business or other business of life insurers where in practicable terms the income of that business is exempt from tax. Failure to do this might result in life insurers ceasing to make such investments, because of concerns around tax compliance failures, which may result in a negative impact on capital markets.

***(c) To the extent that there are difficulties, do these apply equally to both the holder and issuer in***

[5] Markit
[6] Markit

***the context of hybrid financial instruments?***

In the context of issues of regulatory hybrid capital by insurers there would be difficulties for both issuers and holders, particularly relating to identification and the related party rule. However, the difficulties for issuers would be greater, because in most cases it would be practically impossible for them to identify the holders of insurers' regulatory hybrid capital for the reason given in our response to question 4 and 6. In contrast, the holder would at least know it had a holding in an insurers' regulatory hybrid capital, even though they would not necessarily know the tax position of the issuer.

The implications for insurers as issuers are highly significant. Insurance companies as investors could avoid investing in such instruments resulting in some loss of investment return, whereas difficulties for issuers would impact the efficiency and cost of its capital structure which is fundamental to supporting the insurance business.

There would of course still be difficulties for insurers as investors. Insurers invest the premiums received from policyholders in a broad range of instruments. With a "top down" approach it would be a significant and unreasonable compliance burden to expect insurers to review all their investments and to identify the tax treatment in the issuers' jurisdiction. This is particularly so as the scope of "instruments" covered by the proposed rules is very broad. However, with a "bottom up" approach there would not be the same problems provided that the related party limit was increased to a more appropriate level to ensure insurers' portfolio holdings were not treated as related parties.

***(d)Are there any other situations or examples, not covered here that give rise to difficulties? In particular are there any specific problems for regulated businesses (see also Q. 8 below)?***

Where an insurer issues regulatory hybrid capital externally there will generally be a large number of holders of that capital. They will usually have issued more than one tranche of regulatory hybrid capital and therefore the total number of holders of an insurers' regulatory hybrid capital will be large. The size of the debt market that is regulatory capital is we understand in excess of USD2trillion. So, unless externally issued regulatory hybrid capital is carved out from the hybrid financial instrument rule, in addition to the identification difficulties, to which we refer to in our response to question 4 and 6, there would be a significant administrative burden in ascertaining the tax treatment in each holder's jurisdiction. This would be disproportionate, particularly in view of the fact that insurers' regulatory hybrid capital is not designed to create a tax mismatch.

The discussion draft does not cover the situation where a company issues regulatory hybrid capital and allocates the interest deduction between its Key Entrepreneurial Risk Taking ("KERT") functions, so that the total interest cost is allocated between Permanent Establishments (i.e. branches) and the Head Office. In this case, the deductibility of that interest may vary depending where the relevant part of the interest cost is attributed. It would be preferable to have clarity on the intended operation of the rules in this instance. Our presumption is that the intention is to treat each Permanent Establishment separately.

***7. If the rule exempted certain "traded" instruments then how could it be drafted so that it still***

***applied to structured arrangements?***

Any carve out for "traded" instruments would only apply if there were not structured arrangements. A better definition might also be "tradeable" as issuers would not necessarily know the extent of trading in their regulatory hybrid capital if any, but the ability to trade is critical in the pricing issues.

***8. In relation to regulatory capital***

***(a)What are the regulatory requirements for banks' to issue/manage capital at top holding company level, and what arrangements are used to pass this down the group? For example, what use is made of identical and traceable instruments and under what conditions would the arrangement be funded by a market issuance at top holding company level?***

It is not only banks that have regulatory hybrid capital. Insurers also have regulatory hybrid capital which has similar features to that issued by banks. We sent a paper to the OECD on insurers' regulatory hybrid capital to the OECD on 16 December 2013 and have included a copy of the paper in Appendix 2. In the paper we explained the commercial and regulatory background to the issue of regulatory hybrid capital by insurers. We trust that, notwithstanding the omission of any reference to insurers in the discussion document, you would recognise that the commercial and regulatory factors applicable to banks from the issue of regulatory hybrid capital are very similar to those of insurers. Accordingly, the ABI believes that any carve out from the hybrid financial instrument rule for banks should apply equally to insurers.

The decision on where to raise regulatory hybrid capital in an insurance group depends on an array of different commercial factors. However, absent other considerations it would be typical for the company issuing market regulatory hybrid capital to be the entity which heads the group. This is because it is normally this entity that is listed and has the debt rating for the group. It is therefore the easiest and cheapest entity from which to issue regulatory hybrid capital. The different commercial factors that might impact on the decision on where to issue regulatory hybrid capital include local regulatory requirements, regulatory treatment (regulatory capital recognition by intermediate and ultimate holding company regulators), location of ultimate holding company, access to and experience of capital markets and a desire to access a particular market (e.g. for interest rate or foreign exchange reasons). As a result of these considerations regulatory hybrid capital might be issued externally from other companies in an insurer's group including in rare circumstances the insurance operating company. But as stated above, the most usual scenario will be an issue from the entity which heads the group.

There is no single answer to how regulatory hybrid capital is passed down in an insurance group. The passing down typically depends on the regulatory environment and the legal structure of the group. In addition, it may not be practical to trace an intra-group issuance to an external one if the group head is in a different jurisdiction from the entity needing capital. This is because regulatory hybrid capital can have different characteristics in different regulatory and market environments.

It is also worth pointing out that although, generally, there will be an external issue of regulatory hybrid capital, this is not always the case. Whether there is an external issue will depend on the overall capital and funding situation of the group - for example, if the group has sufficient cash and

regulatory surplus at the group level. So, if there is no external issue of regulatory hybrid capital and there is a regulatory and commercial need for regulatory hybrid capital, it will be achieved by means of an intra-group issue.

There may also be timing differences: an insurer may choose to raise the external regulatory hybrid capital early if market conditions are favourable and the need for a capital injection in the subsidiary is foreseeable. Alternatively, if market conditions are unfavourable, an insurer may choose to bridge-fund the capital injection and then issue the externally raised regulatory hybrid capital at a later date.

***(b)Are special provisions needed to create parity between a banking group issuing hybrid regulatory capital indirectly to the market through its holding companies and a banking group (or another industry group) issuing hybrid regulatory capital directly to the market?***

As indicated above, generally there will be an external issue of regulatory hybrid capital, but that is not always the case. Whether there is an external issue will depend on the overall capital and funding situation of the group, for example if the group has sufficient cash and regulatory surplus at the group level. So, if there is no external issue of regulatory hybrid capital and there is a regulatory and commercial need for regulatory hybrid capital, it will be achieved by means of an intra-group issue. Non-EU owned groups may have less capacity, need or ability, to issue hybrid regulatory capital at Group Head Office level. Reasons for this include the Group Head Office Company not being permitted under its local regulatory rules to issue such capital, its local regulator not requiring so much capital and certain businesses within a group, for operational reasons, requiring different leverage ratios than the overall group. However the rationale for using it to fund their EU based operations is the same as for EU owned groups, and can be demonstrated to be consistent with the arm's-length principle provided the terms are accordingly arm's-length. It is also relevant that an internal issue of regulatory capital is subject to the same level of regulatory supervision as an external issuance in the issuers' territory and each regulated entity is subject to the same regulatory limits on capital. As such the ABI believe that there should be parity where regulatory hybrid capital is issued for regulatory purposes and that issued intra group.

***(c)Are hybrid regulatory capital instruments sufficiently different as to justify a full carve-out from hybrid mismatch rules? Are there inherent safeguards in place against the use of these instruments for tax-planning purposes or what safeguards could be introduced to ensure that any exemption from the general hybrid mismatch rules could not be abused?***

The commercial and regulatory environment for both internal and external issues of regulatory hybrid capital instruments by insurers is very different as compared with other hybrid instruments. Insurers' regulatory hybrid capital forms an integral part of their capital and is therefore essential in supporting the trading operations of the insurance industry. Although all industries require capital to operate, the existence of insurers' regulatory hybrid capital is driven by regulatory requirements. Under Solvency I and Solvency II, EU regulators of an insurance group consider the capital adequacy of the consolidated group of entities, taking into account the structural and geographic diversity of the component insurance portfolios. Accordingly, regulatory hybrid capital issuances may inherently be required on a consolidated basis and, therefore, at the level of the group's EU holding company (effectively, the Solvency II top company) which may or may not be the group's parent company, depending on whether the group is ultimately parented by an EU resident company.

The necessity of the intra-group regulated hybrid capital is driven by the fact that the lower-tier subsidiary often cannot issue regulated hybrid capital to the market itself because the regulator of the group generally encourages that the Tier 1 instrument be issued "at the top of the house," i.e. the top EU company. This requirement generally exists because regulatory capital held in a parent company can more easily be redeployed to group members than capital that would be "stuck" in lower-tier subsidiaries. A subsidiary that has issued capital externally cannot deploy that capital readily to other jurisdictions within the group as the regulator of the subsidiary must approve any redemption or movemnet of that capital between parent and subsidiary. This is particularly the case for equity capital, which can require a substantial period of consultation with regulators before such equity capital can be released.

The transfer of capital to lower tier subsidiaries through intra-group regulated hybrid capital is often required by regulators to be accomplished on a true arms-length basis as most regulators want the insurance subsidiaries operating in their jurisdictions to be as independent as possible, from a capital and management standpoint, from their parent companies.

As noted above and earlier, the issue of regulatory hybrid capital takes place because of regulatory requirements and is not issued to create tax mismatches. As such the ABI believe that where regulatory hybrid capital is issued for regulatory purposes both intra group and external issues should be carved out. So there should be a full carve out for insurers' regulatory hybrid capital unless structured arrangements are involved.

There would need to be a definition of regulatory hybrid capital to ensure that only that issued for regulatory purposes would qualify to be carved out. The definition used could be closely linked to the regulatory definitions for banks and insurers respectively.

**3. Hybrid Entity Payments**

We have no comments on the questions raised on hybrid entity payments.

**4. Imported Mismatches and Reverse Hybrids**

We have no comments on the questions raised on hybrid entity payments.

**5. Further Technical Discussion and Examples**

***1. Do these technical recommendations assist in understanding and applying the rules?***

On hybrid instruments, yes, the technical recommendations assist in understanding and applying the rules. On Hybrid Entity Payments the ABI has no comment.

***2. Are there further technical recommendations that should be addressed in the final report.***

No.

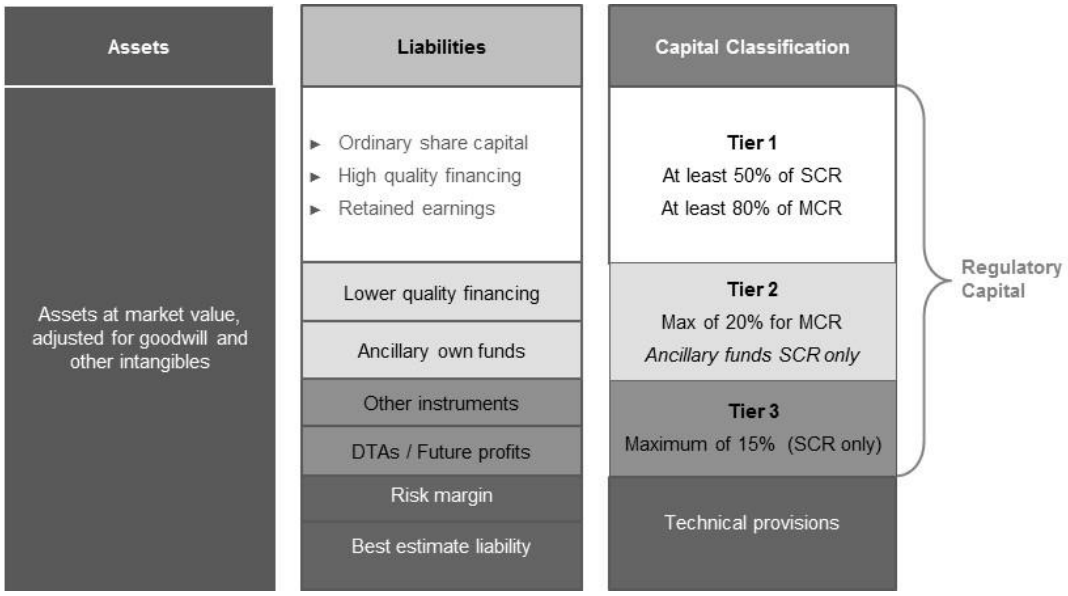
**Association of British Insurers** **2nd May2014**

**Appendix 1 – Regulatory Framework & Capital Adequacy Standards for Insurers**

Insurance groups must hold sufficient regulatory capital to cover the risk of their assets not being sufficient to cover their insurance liabilities. Capital adequacy standards define the amount of capital which an insurance company must hold and detail the characteristics which regulatory capital must meet in order to qualify as such. Debt instruments, which form an integral part of the regulatory capital of insurers, have certain equity-like features (relating to loss absorbency and interest deferral) which are mandated by regulators. This means that these debt instruments can fall within some definitions of a hybrid instrument for tax purposes. However, these equity-like features which are mandated by legislation are not designed to give a tax mismatch and are essential in supporting the trading operations of the insurance industry.

The Solvency II Directive[7] codifies and harmonises insurance regulation in the EU and is scheduled to come into effect on 1 January 2016. Capital adequacy standards will become more stringent under Solvency II for EU (re)insurance companies, to reduce the risk of insolvency. The regime is intended to be more sophisticated and risk sensitive than the current insurance regulatory regime.

Under Solvency II, the required regulatory capital of an insurance company is be divided into 3 'tiers'[8] (Tier 1 to Tier 3) based on both its 'permanence' and its 'loss absorbency' characteristics. The "tier" of capital in which an instrument falls will be determined by factors such as its quality, liquidity, duration, permanence and the obligations of the insurer under its terms to pay distributions or interest. Tier 1 is the capital of the highest quality and the majority of an insurer's regulatory capital must be Tier 1 capital. The majority of regulatory debt instruments are designed to fall within either Tier 1 or Tier 2.




Solvency II sets limits on the amount of Tier 1, Tier 2 and Tier 3 capital that can be held to cover an insurance company's capital requirements, to ensure that the insurer has sufficient capital to absorb

[7] 2009/138/EC

[8] Under Solvency II, the regulatory capital of an insurer is called 'own funds'. However, the term "regulatory capital" is used in this paper. The requirements for the "tiers" of capital apply equally to insurance companies and the "regulated" EU holding company

any losses that might arise. As with all companies, there is an optimum capital structure under which insurance companies aim to operate. Although more expensive than senior debt, regulatory debt instruments are significantly cheaper than equity. Using too much equity increases the overall cost of capital while using too much debt increases the risk profile of the business due to the obligation on the business to service the debt.

**Purpose of Capital Requirements under Solvency II**

The regulation of insurance companies is similar in principle to that of the banking sector. The solvency capital requirement of an insurer has the following purposes:

- To reduce the risk that an insurer would be unable to meet any claims;
- To reduce the losses suffered by policyholders in the event that a firm is unable to meet all claims fully;
- To provide an early warning to supervisors so that they can intervene promptly if an insurers capital falls below the required level; and
- To promote confidence in the financial stability of the insurance sector.

Under Solvency II, there are two principle capital requirements of an insurer.

- The main capital requirement is the Solvency Capital Requirement ("SCR"). The SCR is the capital required to ensure that the (re)insurance company will be able to meet its obligations over the next 12 months with a probability of at least 99.5%.
- In addition to the SCR capital, a Minimum Capital Requirement ("MCR") must be calculated which represents the threshold below which the national insurance regulator would intervene. The MCR is intended to correspond to an 85% probability of adequacy over a one year period.

The limits for capital instruments covering the MCR are the most restrictive. The MCR must be made up of Tier 1 and Tier 2 capital only and at least 80% of the capital used to cover the MCR must be Tier 1 capital. For the SCR, at least 50% per cent of the capital making up the SCR must be Tier 1.

It is also expected that at least 80% of Tier 1 items should be "unrestricted" Tier 1; with no more than 20% being "restricted" Tier 1. Tier 2 can be up to 50% and Tier 3 can be no more than 15% of eligible capital. If the limit for one tier is exceeded, the item may still be capable of being counted in a lower tier (i.e. restricted tier 1 capital may count as Tier 2 capital if the 20% cap is reached).

In practice, (re)insurance companies will hold an additional capital "buffer" over and above the MCR and SCR for prudence (and this is generally required in practice by insurance regulators and the rating agencies). For supervisory purposes, the SCR and MCR act as regulatory triggers. The insurance regulator would intervene once the capital holding of the (re)insurance company (or holding company) falls below the SCR, with the intervention becoming progressively more intense as the amount of regulatory capital held approaches the MCR.

The Solvency II capital requirements apply equally to each active insurance company in a group of companies and also to the ultimate EU holding company of an insurance group. Each insurance entity and group holding company must hold sufficient regulatory capital which meets the Solvency II

capital requirements. Where the parent company of a group of companies is located outside of the EU, the Solvency II requirements will apply to the "top" EU holding company.

The Solvency II Directive provides regional supervisors with a number of discretions to address breaches of the MCR, including the withdrawal of authorisation from selling new insurance business and, in extreme cases, the winding up of the company.

**Detailed requirements for regulatory capital instruments**

It is a requirement under Solvency II that all capital instruments should not:

- rank before policyholder or non-subordinated creditors on insolvency;
- include encumbrances or connected transactions (e.g. guarantees or reciprocal financing arrangements);
- pay distributions/coupons whilst in breach of the SCR; and
- be redeemed without prior approval by the insurance regulator.

Under Solvency II, regulatory capital instruments must be "loss absorbing" on an ongoing and/or on a winding up basis. The ability of an instrument to permanently absorb losses on a "going concern" basis or only in the event of a winding up (a "gone" concern) is key in determining which tier of capital an instrument will fall within. It is also a requirement that such instruments should not include terms which could cause or accelerate the insurer's insolvency. The rules also have duration requirements which apply to each 'tier' of capital in order to satisfy the permanence requirements. In addition, insurers need to ensure that the duration of instruments is consistent with the duration of their liabilities. The detailed implications of these requirements for the tiers of capital are as follows:

*Tier 1*
Tier 1 capital instruments include ordinary share capital, non-cumulative preference shares and certain sub-ordinated liabilities. All distributions on Tier 1 items must be cancelled in the event of a breach of the SCR and repayment of principal must be suspended. Preference shares and sub-ordinated debt are subject to the 'loss absorption' requirement (described below) which could involve writing-off all amounts owed by the insurer to the holders of the instruments. Under Solvency II, "unrestricted" Tier 1 capital must make up at least 80% of total Tier 1 funds. Unrestricted Tier 1 will be made up of ordinary shares plus share premium. It will also include surplus funds meeting the full requirements for subordination and permanence.

"Restricted" Tier 1 items include paid in subordinated preference shares and certain subordinated liabilities. This type of capital is limited to a maximum of 20% of the Tier 1 capital of an insurer.

The 'Tier 1' loss absorption requirement applies where:

- where an insurer holds less than 75% of its SCR;
- where it breaches its MCR; or
- where it breaches its SCR for more than 3 months.

In these circumstances, there must be an automatic writing down of the liability of the insurer (principal and dividend/coupon), a conversion to ordinary shares or use of an 'equivalent mechanism' (i.e. similar to writing down or conversion).

*Tier 2*
Tier 2 'capital' is likely to include cumulative preference shares, and sub-ordinated liabilities with a shorter duration. Unlike Tier 1 instruments, the principal need not be written down or converted following a serious breach of the solvency requirements. Tier 2 may therefore also include shares or long term debt which does not comply with the loss absorption requirement described above. All distributions on Tier 2 shares must be suspended following a breach of the SCR whereas coupon and other amounts owing on debt and capital instruments must be cancelled. Therefore, debt to be included within Tier 2 can encompass both debt with hybrid characteristics (though of shorter duration that Tier 1 instruments) as well as other sub-ordinated liabilities.

*Tier 3*
Tier 3 capital is all capital items which do not satisfy the Tier 1 or Tier 2 requirements. Tier 3 items must have an original maturity of at least 3 years and need only suspend distributions (not interest/coupons on debt) on breach of the MCR (and not the SCR). However, breach of the SCR would still trigger a suspension of repayment of principal amounts. Certain net deferred tax assets also count towards Tier 3 capital.

*Incentives to redeem*
Tier 1 and Tier 2 capital can only be redeemed at the option of the insurer. Tier 1 items cannot include incentives to redeem. Tier 2 own funds may include 'limited' incentives to redeem provided this does not happen in the first 10 years. Tier 3 instruments can be redeemed by either party after 3 years. All redemptions, conversions and exchanges of all capital instruments require the prior approval of the supervisor.

The capital requirements of an insurance company under Solvency II can be summarised as follows:

| Classification | Key features of instruments |
|---|---|
| **Tier 1**<br><br>At least 50% of SCR<br><br>At least 80% of MCR<br><br>20% “restricted” capital | ▸ Subordination<br><br>▸ Loss absorbency on going concern basis<br><br>▸ Sufficient duration – undated (earliest redemption at 5 years;10 years if under SCR);<br><br>▸ Free from requirements or incentives to redeem<br><br>▸ Free from mandatory fixed charges<br><br>▸ Absence of encumbrances<br><br>▸ “Restricted” Tier 1 – limited to 20% of Tier 1. Very heavily subordinated debt. |

| | |
|---|---|
| **Tier 2**<br><br>Max of 20% for MCR<br><br>*Ancillary own funds SCR only* | ▸ Subordination<br><br>▸ Loss absorbency on wind-up concern basis<br><br>▸ Sufficient duration – 10 years minimum duration at issue, earliest redemption at 5 years.<br><br>▸ Only moderate incentives to redeem<br><br>▸ Free from mandatory fixed charges; absence of encumbrances<br><br>▸ *Ancillary funds include unpaid but must be callable on demand and constitute Tier 1 capital when paid – subject to regulatory approval* |
| **Tier 3**<br><br>Maximum of 15% (SCR only)<br><br>*Ancillary own funds SCR only* | ▸ Tier 3 basic own funds should not be freely redeemable (or coupons payable) when solvency is deteriorating<br><br>▸ Must demonstrate effective subordination<br><br>▸ 3 years minimum duration at issue<br><br>▸ *Ancillary funds include unpaid but must be callable on demand. Tier 3 if not Tier 1 when paid in – subject to regulatory approval* |

Redemption in each case is subject to prior approval of the regulator.

Association of British Insurers

**Appendix 2 – ABI paper to OECD on regulatory hybrid capital dated 16 December 2013**

**Summary**
All industries require capital to operate, but insurers are required to hold their capital subject to specific regulatory rules. The issue of hybrid regulatory capital has been driven by regulation and should not in any way whatsoever be regarded as driven by tax avoidance or as constituting harmful tax practices.

Insurance groups are required to meet capital adequacy standards and the debt instruments which can count towards their capital have certain equity-like features mandated by the local regulators (or the European regulators when Solvency II comes into effect in 2016) relating to loss absorbency and interest deferral. This means that these instruments can fall within some definitions of a hybrid instrument. However, these equity-like features which are mandated by legislation are not designed to give a tax mismatch. Furthermore, they form an integral part of the capital of insurers and therefore are essential in supporting the trading operations of the insurance industry.

The tax deductibility of interest on regulatory hybrid capital is important to insurance groups and is likely to have been one of the economic factors taken into account at the time of issue of regulatory hybrid capital. The removal of tax relief could impact on profits and therefore on capital and liquidity, and as a result could give rise to concerns to issuers and regulators. It could also add to negative pressure on insurers' credit rating, share price, the general attractiveness of insurers to investors and insurers' access to capital markets.

If interest deductibility on regulatory hybrid capital were removed there would likely to be an overall increase in the cost of capital. As a result of this there would likely be an impact on product pricing and/or analysts' profit models, valuations and costs to the customer. There would be an additional cost to the insurance industry in raising capital that other industries can avoid as they have freedom to raise different forms of (non-hybrid) debt.

**Introduction**
The insurance industry fully supports the aim of the OECD Action Plan on BEPS and in particular the intention of Action 2 to "Neutralise the effects of hybrid mismatch arrangements". This paper provides information on how the insurance industry makes use of regulatory hybrid capital as part of its capital management practices and explains why this is not related to any tax avoidance motive. The following areas are covered:

1. an overview of the capital structure of insurance companies and background on why insurers issue regulatory hybrid capital.
2. the commercial and regulatory factors that influence the issue of regulatory hybrid capital.
3. the changes in the regulatory position on the move from Solvency I to Solvency II.
4. details of the impact of removing tax deductibility of regulatory hybrid capital.
5. an explanation of why insurers' regulatory hybrid capital should not be regarded as constituting harmful tax practices.
6. suggestions of how harmful tax practices could be tackled without impacting on purely commercial issues of regulatory hybrid capital .

1. **Overview of capital structure of insurance companies and the background to why insurers issue regulatory hybrid capital**

As with all companies, there is an optimum capital structure under which insurance companies aim to operate. Although more expensive than senior debt, regulatory hybrid capital, which has loss absorbency characteristics and forms part of an insurers' regulatory capital, is significantly cheaper than equity. Using too much equity increases the overall cost of capital while using too much debt increases the risk profile of the business due to the obligation on the business to service the debt.

As such, an insurer's ability to raise debt is constrained by, amongst other stakeholders, rating agencies' views of the creditworthiness of the Group which would be impacted by a high leverage ratio. For example, Groups that maintain leverage ratios in excess of 30% (on a Standard & Poors or Moody's basis) for extended periods of time would be viewed as highly leveraged by those rating agencies. Further, the EU Insurance Groups Directive (IGD) regime places capacity limits on the amount of regulatory hybrid capital that is admissible as regulatory capital relative to pure equity.

Over the past decade the UK insurance industry has been both incentivised and required to issue regulatory hybrid capital rather than senior debt in attempting to achieve the optimum mix of debt and equity in the capital structure. The reasons for the industry-wide move to regulatory hybrid capital are as follows:

- A general trend of regulators becoming more prudent and requiring insurers to hold greater levels of capital for the same risks than had been the case previously, improving ability to withstand shocks in the financial markets.
- The introduction of the IGD in 2004 requiring EU Group solvency tests; previously senior debt could be raised by holding companies and injected into operating subsidiaries as regulatory capital; following implementation of the IGD regime, groups had to replace this external senior debt with either equity or regulatory hybrid capital.
- Under the IGD regime senior debt is inadmissible as regulatory capital.
- Regulatory hybrid capital with equity features is considered an attractive, cost-efficient means of raising non-dilutive capital.

2. **The commercial and regulatory factors that influence the issue of regulatory hybrid capital**

There are very good non-tax reasons for insurers to issue regulatory hybrid capital. The regulatory environment requires institutions to hold regulatory capital with high loss absorbency but recognises the high cost of capital associated with holding only Tier 1 capital and so provides for institutions to hold innovative Tier 1[9] and Tier 2, which can be regarded as regulatory hybrid capital.

For quoted insurance groups, Return on Capital Employed (ROCE) is a key measure of economic success and managing both the amount of capital and the cost of it is a key part of the business model.

Debt carries less risk for the investor and as a result is a cheaper form of capital than equity. Within the category of debt, there are then different levels of risk with senior debt such as commercial paper being relatively cheap and regulatory hybrid capital which will be more

[9] Tier 1 and Tier 2 capital forms part of the regulatory capital of insurers

expensive. This reflects the loss absorbency of regulatory hybrid capital and its subordination for repayment in a winding up.

The amount of regulatory hybrid capital that can be recognised as regulatory capital is capped relative to the amount of equity capital and this will therefore inform any base level decision regarding the balance between debt and equity. As regulation has developed this balance has also changed. The introduction of the IGD in 2004, which brought in a Group level solvency test for the first time, resulted in a significant shift in the capital profile of insurance groups.

The IGD regime does not permit senior debt to be included as regulatory capital. As a result, the move to regulatory hybrid capital started around 2001 in preparation for the introduction of the Group Directive in 2004. At a basic level, IGD permits insurers to raise around 50% of total regulatory capital in the form of regulatory hybrid capital. Although there are regulatory limits on the amounts of regulatory hybrid capital which qualifies as regulatory capital, it is beneficial (particularly the cost efficiencies and the flexibility) for insurance companies to raise regulatory hybrid capital in preference to equity, within the constraints imposed by other stakeholders such as rating agencies. Note that rating agencies play a key role in assessing the capital strength of insurers, with a "AA" rating being the standard aim for a large insurance group and therefore the rating agency views on capital are critically important as well as the regulatory view.

3. **Changes in the Regulatory position on the move from Solvency I to Solvency II**
Although implementation of Solvency II is not expected before 2016, the Regulator already requires any new issues to be "in the direction of travel" of Solvency II requirements.

The Solvency II Tier 1 requirements are not yet finalised, however the main types of features that are now expected to be required for Tier 2 issues include:

- Mandatory coupon deferral upon breach of Solvency II Capital Requirements.
- Redemption of regulatory hybrid capital is subject to satisfying Solvency II Capital Requirements.
- Minimum term to maturity of 10 years (with the first call date not being prior to year 5).

Although the term of hybrid debt may be 10 or 30 years or even perpetual, these generally have an option for the borrower to call in the debt after 5 years. In practice this is always done because there would be a provision in the documentation for the interest rate to increase after this 5 year period. Therefore the hybrid debt in reality is much closer to normal senior debt in the way it is used than it is to equity. The regulatory features are included to provide the capital recognition but are there to be used only in extreme situations.

Following the introduction of Solvency II there is an expectation that there will be a 10 year transition period for any regulatory hybrid capital in issue at that date. During this period such capital will continue to be recognised broadly as regulatory capital and this transition is likely to be adequate to manage the position.

Also, many regulatory hybrid capital instruments provide for a renegotiation feature on a change to the regulatory regime. Therefore some instruments may be amended and capital structures optimised on the introduction of Solvency II with the new issuance of Solvency II capital instruments at that time.

4. **The impact of removing tax deductibility of regulatory hybrid capital**
Although regulatory hybrid capital is issued purely to raise capital and is not issued to avoid tax, the tax deductibility of interest is very important to large insurance groups and would likely to have been taken into account at the time of issue of regulatory hybrid capital. The removal of tax relief could raise concerns as a result of the impact on profits, capital and liquidity. It could also impact negatively on insurer's credit rating, share price, the general attractiveness of insurers to investors. This would be reflected in the associated increase in the cost of capital potentially impacting on product pricing and/or analysts' profit models and valuations and costs to the customer.

The factors outlined in the paragraph above would impact on competiveness. The capital structure of insurers has been dictated by the rules for Solvency I and the introduction of the Group Directive by the EU in 2004. This required that insurance groups met Group level Solvency tests at the Group level as well as at the individual company level. This required EU insurers to hold more loss absorbing capital (this includes regulatory hybrid capital) and was one of the main reasons for the move away from cheap senior debt (such as commercial paper programmes) to regulatory hybrid capital. These requirements do not apply for example in the US, where insurers can still provide capital to their insurance operating entities via cheap senior debt raised at holding company level, although this is still subject to constraints from the rating agencies.

Therefore the costs of capital for EU insurers are likely to be higher than for example, US insurers, just based on the fact that European insurance capital positions are subject to stricter Solvency rules such as the assessment at a Group level. It also means that the insurance industry may have to pay more to borrow than companies in other industries that do not need to raise more expensive regulatory hybrid capital to maintain their capital levels.

Layering non tax deductibility on top of this could further erode the competitive position of EU based insurers or insurers in other territories where full Solvency II equivalent rules are being introduced. Note the US is expected to be granted Solvency II equivalence without necessarily changing insurance regulation – which applies at State level.

As referred to in section 1 insurers cannot raise normal senior debt and have it count as regulatory capital and therefore, if the tax deductibility of regulatory hybrid capital were removed, the EU insurance industry would not be left with any form of tax deductible borrowing for capital.

It is difficult to quantify exactly what the financial impact of removal of tax relief would be. However, it has been estimated by more than one insurer that the removal of tax relief on hybrids could increase the weighted average cost of capital by about 50 basis points. For highly geared groups, the costs could be higher.

5. **Why insurers' regulatory hybrid capital should not be regarded as constituting harmful tax practices**
As indicated above insurers issue regulatory hybrid capital as part of their capital regulatory requirements, the features of which are dictated by the regulator. Insurers'regulatory hybrid capital also has the following features that mean it does not constitute harmful tax practices.

- It is not specifically designed to create tax mismatches.
- The investors who acquire externally issued regulatory hybrid capital are not normally connected to the issuer.
- The identity of the investors in externally issued regulatory hybrid capital will often be unknown to the issuer as will the tax treatment of the regulatory hybrid capital in the investor's jurisdiction.
- Insurers are seeking to obtain a tax deduction for interest once and once only for interest on debt
- Large multinational groups may issue regulatory hybrid capital internally where, for example, the group wants to improve capital efficiencies in its non-home state insurance subsidiaries but centrally manage its capital including issuances to market from its home state.

It is also worth making the point that insurers would not be in a position to identify the tax treatment of regulatory hybrid capital in the hands of third party investors and obtaining a tax deduction should not be made dependant on this, unless there is a connected party involved.

6. **Possible solutions of how harmful tax practices could be tackled without impacting on purely commercial issues of regulatory hybrid capital by insurers**

The view of the ABI is that any solution to tackle hybrids that constitute harmful tax practices should be targeted at hybrids that are deliberately designed to create tax mismatches. Any solution should not catch regulatory hybrid capital issued by insurers which has a bona fide commercial purpose. The following solutions would appear to meet the objectives of nullifying deliberately created mismatches, but at the same time would not impact on purely commercial issues of regulatory debt:

- The introduction by tax authorities of anti-hybrid rules which include a tax avoidance purpose test, similar to the UK rules, and/or
- Specifically exclude insurers' regulatory capital from any anti-hybrid tax rule, and/ or
- Specifically exclude issues of regulatory hybrid capital issued on the open market from any anti-avoidance test / requirement to demonstrate the taxation basis of the recipient.
- Specifically exclude intra group regulatory hybrid capital where it can be evidenced that the holder of the instrument is subject to taxation on the income.

**Conclusion**

The insurance industry fully supports the need for restrictions on double deductions of interest and avoidance schemes to ensure no taxation on receipts on interest paid. We believe that there are methods of tackling the abuse of hybrid instruments that do not involve restrictions on the tax deduction of insurer's regulatory hybrid capital. These options should be given serious consideration in order to avoid any unintended distortion of competition for insurers – with capital raising becoming more expensive as compared with other industries. There is also the possibility that EU /fully Solvency II compliant insurers will be further disadvantaged as compared to insurers in other location with more freedom of action on capital structure.

Ultimately, increases in the cost of capital for insurers arising as a result will be passed on to consumers in higher insurance costs. The focus of the OECD action plan should rightly be on collecting the right amount of tax by tackling tax avoidance, but increasing costs for consumers

by adding to costs for all insurers across the board regardless of whether any tax avoidance is involved should be avoided.

16th December 2013

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| IMB/HK | 020 7604 8073 | 1 May 2014 |

Dear Sir/Madam

**OECD Discussion Draft on BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements**

Thank you for the opportunity to comment on the OECD's discussion draft on Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements, as issued on 19 March 2014.

***General Comments***

The proposals included in the discussion draft are likely to have a significant impact on international business and have been provided at a time when business is already being asked to consider and comment upon a large quantity of similar discussion drafts issued by the OECD. We would caution that sufficient time must be provided for the relatively complex recommendations on hybrid mismatch arrangements to be fully considered and understood by the relevant stakeholders and that any conclusions are co-ordinated with, and finalised at the same time as, the BEPS Actions regarding CFC rules, interest deductibility and harmful tax practices, which are not due to report until 2015. Failure to provide adequate opportunity for reflection on the proposals and their interaction with the recommendations arising from the OECD's work on the other BEPS Action Plan items is likely to result in conflict on application and risk of double taxation.

We understand the OECD's desire to address the effect of structured hybrid mismatch arrangements, however, any measures that are introduced in this area should be clearly targeted, proportionate to the abuse and should not impose undue compliance burdens. In addition, BEPS Action 2 should not seek to over-ride domestic tax policy choices e.g. government tax incentives.

The design principles outlined in Part II of the discussion draft meet a number of the criteria for good rule design, but we feel strongly that there should be some form of avoidance qualification or "main purpose" test to ensure that companies are not inadvertently and inappropriately caught by the rules. In addition, we would question whether the criteria proposed successfully meet the design principles in each instance. We have identified below some of the key issues in this respect, as part of our comments on the rules relating to the specific categories of hybrid mismatch arrangements highlighted in the discussion draft.

One of our primary concerns (which is equally applicable to the proposed rules for each category of hybrid arrangement) is that it appears unlikely that the comprehensive, consistent application of the proposed rules envisaged by the discussion draft would be achievable. Firstly, it is unlikely that all jurisdictions would adopt the proposed rules in the form specifically recommended by the

discussion draft. Secondly, it seems inevitable, given the number of diverse domestic tax regimes in point, that differences in the interpretation of key terms driving the impact of the rules (e.g. financial instrument), will give rise to some degree of difference in application. The introduction of the proposed rules on the incomplete and inconsistent basis anticipated, could lead to a significant increase in compliance costs for MNE groups without realising a commensurate reduction in transactional risk.

We also note that the discussion document does not consider the need for grandfathering rules to carve out hybrid mismatch arrangements which the taxpayer obviously did not intend to use to achieve BEPS (for example, existing structures in a target group which are inherited through acquisition). Nor are any transitional rules proposed to enable the taxpayer to restructure existing arrangements within a reasonable period and without any incremental tax cost. In our view, such rules will be critical to ensure that the linking rules to neutralise tax mismatches are properly targeted.

***Hybrid Financial Instruments and Transfers***

- We do not believe that the proposed rules regarding the treatment of hybrid financial instruments and transfers meet the stated design principle of being workable for tax payers and keeping compliance costs to a minimum. As currently envisaged, the proposals would require companies to take a tax position based on:

  a) the ordinary tax treatment of a payment in the counterparty jurisdiction;
  b) whether the counterparty jurisdiction would deny a deduction under the primary rule (if the relevant company is the payee); and
  c) the anticipated future tax treatment of a payment in the counterparty jurisdiction (to determine whether any mismatch arising is merely a timing difference).

  Understanding each of the above is likely to require a substantial amount of technical analysis, leading to a significant increase in the compliance costs of MNE groups, especially where a top-down approach is adopted.

- In terms of the wider advantages/disadvantages of a top-down approach compared to a bottom-up approach, we strongly prefer a bottom-up approach and believe this is more in line with the design principles set out in Part II of the discussion draft.

  A bottom-up approach is likely to reduce both compliance costs for the tax payer and the resources required for the tax authorities to administer the rules. This is because a more targeted, risk based approach should reduce the number of arrangements which need to be analysed both by tax payers when taking a tax position and by tax authorities in the event of an audit. In addition, the rules could be designed to specifically target

those arrangements that engineer mismatches which raise genuine policy issues.

Rules drafted in line with a bottom-up approach are also likely to be clearer and more transparent in application. This is due to the expected degree of reliance placed by the top-down approach on what could be a significant list of exemptions, each of which would be open to multiple interpretations.

- We note that the proposed rules do not provide for an exemption for D/NI arrangements arising under hybrid financial instruments where a non-taxable payment is brought within the charge to tax by CFC or equivalent rules in a third jurisdiction. We are concerned that this could result in a significant risk of double taxation.

- It is intended that the hybrid financial instrument rule would apply to all instruments held between "related parties", with the test for related party status set at 10%. We believe that this threshold is far too low, and the definition of a related party should refer to a significant element of control, by reference to economic interest or voting power i.e. 40% rather than 10%. From a practical perspective, if the threshold is retained at 10%, it could be very difficult for tax payers to obtain the information required to take an accurate position under the proposed rules. An unconnected party is likely to be unwilling to share details of their tax affairs for commercial reasons and there may be little motivation to undertake the additional administration associated with providing the requisite information. Given this, we believe the scope of the measures should be restricted to "profit shifting arrangements" between related parties (with the threshold raised to 40%), and should only apply to third party transactions where they facilitate or are a party to abusive, structured arrangements. Any publicly-traded instrument should be specifically excluded e.g. convertible debt and hybrid debt.

***Hybrid Entity Payments***

- As with the proposed rules regarding hybrid financial instruments and transfers, requiring companies to take a tax position based on the tax treatment of a payment by another jurisdiction does not appear to be a solution that would be easy to administer by either tax payers or taxing authorities. Indeed, the rules regarding hybrid entity payments could add even further to the compliance burden by requiring companies to maintain a record of streamed losses.

***Imported Mismatches and Reverse Hybrids***

- The introduction of any primary rule requiring the income to be included in the investor jurisdiction by the application of anti-deferral rules, such as CFC rules, should be coordinated with the recommendations to strengthen the CFC rules under Action 3.

- As with the other proposals included in the discussion draft, obtaining sufficient information regarding the counterparty tax treatment of a payment to be able to take an accurate tax position under the rules regarding imported mismatches and reverse hybrids is likely to add to the compliance burden of MNE groups and taxing authorities. This will be particularly so for imported mismatch arrangements as the rules in this area would require companies to obtain an understanding of the corresponding tax treatment of an arrangement in more than one additional overseas jurisdiction.

- We have concerns that the benefits arising from prescribing standardized information reporting requirements for intermediary jurisdictions discussed at paragraph 222 would not justify the additional compliance costs generated. The CFC/FIF rules applicable in each jurisdiction vary considerably, with the result that it would be difficult and potentially onerous to design a reporting requirement that is useful and relevant to all. Any reporting requirement developed or introduced with the prevention of such mismatch arrangements in mind is therefore expected to result in an unjustified administrative burden, the output of which would never be utilised.

- We would also raise the more practical question as to how any such reporting requirement could be targeted to specifically apply to those intermediaries involved in imported mismatches or reverse hybrid schemes, particularly if they do not have a taxable presence in the relevant jurisdiction.

- We welcome the suggestion at paragraph 236 that safe harbours could be provided to prevent the resource requirement for a detailed analysis of the overseas tax treatment of an arrangement in those instances where the tax risk is relatively low.

Yours faithfully

Ian Brimicombe

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2 May 2014

Mr Pascal Saint-Amans
Director, Centre for Tax Policy and Administration, and

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Head, International Co-operation and Tax Administration Division
OECD/CTPA

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Dear Sirs,

**Re: BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements**

This submission has been prepared by the Australian Bankers' Association (**ABA**), in response to the request for comments on the two documents released by the OECD in March 2014: *Public Discussion Draft – BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendation for Domestic Laws)* and *Public Discussion Draft – BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)*. The ABA welcomes the opportunity to comment on the Public Discussion Drafts.

These comments are directed principally to the *Public Discussion Draft – BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendation for Domestic Laws)* (**Domestic Draft**) and focus on concerns that are particular to the banking industry, especially with respect to the proposals for "hybrid financial instruments."

The ABA is the peak national body representing banks that are authorised by the Australian Prudential Regulation Authority to carry on banking business in Australia. The ABA's membership of 24 banks comprises the four major banks, former regional banks that now operate nationally, foreign banks that are represented and carry on banking business in Australia as Australian banks and a mutual bank.

The import of this submission is to reinforce the need to ensure that any recommendations for hybrid-specific rules which emerge from this project emphasise very clearly that domestic rules should:

i. be clear and simple;

ii. be certain in their scope, application and effect;

iii. not lead to impractical or excessive compliance requirements or unintended consequences;

iv. recognise the need for banks to issue hybrid capital in managing their prudential requirements; and

v. be sufficiently flexible to accommodate the frequent changes to the regulatory environment in which the banking industry operates.

These design parameters are particularly important for the banking industry for reasons that are explained below. While these matters are alluded to in the Domestic Draft, the ABA submits that the final recommendations to countries should emphasise more clearly and fully some of the limitations on scope and operation of the hybrid-specific rules that are currently in the Domestic Draft. Put another way, considerations already noted in the Domestic Draft – that the rules should be "clear and transparent in their operation", "workable for taxpayers" and "easy for tax authorities to administer" [para 27] – need greater prominence and their implications need to be to be expressed more fully. Our specific comments are outlined below.

## 1. Additional Tier 1 Capital instruments

One of the repercussions of the financial crisis of circa 2008 and the Third Basel Accord has been the requirement by national financial regulators for banks to increase the level of their regulatory capital permanently invested in the bank and available to absorb losses. In Australia, the Australian Prudential Regulation Authority (**APRA**), the prudential regulator of the financial services industry, has been actively ensuring that Australian banks meet these enhanced capital adequacy requirements.

In order to meet these heightened regulatory requirements several Australian banks have already had to increase the level of their Tier 1 Capital. Tier 1 Capital can be either Common Equity Tier 1 Capital (typically ordinary shares, retained and current year earnings and certain other reserves) or Additional Tier 1 Capital. Additional Tier 1 Capital instruments are not Common Equity Tier 1 Capital but nevertheless represent a permanent and unrestricted commitment of funds, which rank behind the claims of depositors and senior creditors in the event of winding up of the issuer and provide for discretionary capital distributions. They may be issued as equity in form (for example, preferred shares) or the form of debt (for example, deferred or converting debt). As Additional Tier 1 Capital instruments will not be conventional debt or equity in form, they can represent an instance of the "hybrid financial instruments" discussed in Part IV of the Domestic Draft, depending on their treatment both in Australia and offshore.

The recent experience of the Australian banking industry has demonstrated a strong market demand for products which are Additional Tier 1 Capital. They offer higher returns than traditional debt-based products. Part of that attraction also comes from the fact that these instruments can be easily traded on markets. And a third feature which makes these instruments appealing to some classes of institutions (especially charities and pension funds which often face restrictions if investing in equity) is that instruments which are debt-based may fall outside these restrictions. From the issuer's perspective, Additional Tier 1 Capital instruments have the advantage that they allow banks to raise additional capital which will meet the regulatory test of Tier 1 Capital but at a cost of funds that is substantially lower than the cost of servicing Common Tier 1 Equity instruments. Consequently many recent and significant capital raisings have been undertaken by Australian banks in this form.

These instruments can appear complex to those unfamiliar with the banking industry, especially if multiple instruments are stapled to create a single commercial investment. Nevertheless, they take their form for the reasons just outlined – the requirements of the banking regulator about the design of the instrument, the appetite of the market for these kinds of instruments, and their attractiveness to issuers compared with Common Tier 1 Equity. None of these explanations involves any tax considerations. Any tax mismatches which might occur cross-border are therefore incidental, and are largely outside the control of the issuers.

In these circumstances, it is very important that this project does not result in recommendations which would preclude, or unduly impede, the banking industry from continuing to raise capital in this form.

## 2. Current proposal for hybrid regulatory capital – instruments issued directly to market

The discussion of this issue in the Domestic Draft [paras 158 ff] is welcome recognition of the need for special attention to this kind of instrument. However, the approach in the Domestic Draft should be strengthened so that this project is more likely to lead to rules that are "clear and transparent in their operation" and "workable for taxpayers".

The Domestic Draft appears to take the view that no specific exception from the recommendations made in Part IV is required for hybrid regulatory capital instruments that are issued by banks directly to the market:

> *[they are] unlikely to be caught by either a related-party hybrid mismatch rule, or a more widely drafted rule that contains a specific carve out for 'widely-held' or 'traded' instruments [para 160].*

Because of the importance of this issue, the ABA's view is that it is not appropriate simply to hope that the matter will be fully and adequately dealt with by those rules. Rather, the final recommendations for national legislators should include a specific exception for instruments which are Additional Tier 1 Capital or which are raised to service such instruments. There are several reasons:

- A poorly drafted "related party" exception could unwittingly include these instruments within its scope on the basis that the instrument was *issued to* a related party (ignoring the implication in the text that the treatment of an instrument should be based on the identity of the holder at the relevant time);
- The level at which parties will be 'related' is currently proposed to be 10%. This would create problems for banks which issue instruments to offshore funding subsidiaries in which they have to retain a minority interest for reasons of market confidence. (An example is described in the Australian court decision *St George Bank Ltd* [2009] FACFC 62 where St George Bank invested USD100m into a US entity so that this entity could approach the market for a further USD250m);
- Para 125 proposes that, "the hybrid financial instrument rule would apply to all instruments held between related parties (including persons acting in concert) and hybrid financial instruments entered into as part of a 'structured' arrangement." Again, a poorly drafted domestic rule could unwittingly treat these instruments as involving parties "acting in concert" or as forming part of a "structured arrangement", despite the absence of key factors; and
- Even if the domestic law does take seriously the requirements for entities to be regarded as "acting in concert" or an instrument being part of a "structured arrangement", the law may nevertheless place

the onus onto the bank of proving this fact, adding an unnecessary obstacle to the capital raising and diminishing tax certainty for issuers.

Consequently, the ABA's view is that the final recommendations should include a specific exception for instruments which are Additional Tier 1 Capital.

The rule should extend to instruments issued by other companies in the same group which serve to fund such an instrument – the issue is similar to that discussed in the Domestic Draft about the treatment of instruments issued and held between members of a financial conglomerate [para 160]. It notes that, "a number of regulators are encouraging banking groups domiciled in their jurisdiction to issue all their loss absorbing capital at top holding company level and then pass this capital down through the group to the relevant operating subsidiaries" and then goes on to examine just the treatment of the intra-group instruments, presumably on the assumption that the instrument issued by the "top holding company" would qualify for one of the two exceptions. It is important that any exception for hybrid regulatory capital instruments is not rendered ineffective by being confined just to instruments when issued by an entity that is a bank; these instruments are increasingly being issued by entities that are not themselves banks but which own or are owned by banks.

## 3. Current proposal for hybrid regulatory capital – instruments issued intra-group

The discussion in the Domestic Draft notes the possibility of a "co-ordination rule which allows the tax effect of the issuer's deduction to be passed down through chains of related parties to the ultimate borrower". The ABA supports this notion – the specific exemption for instruments which are Additional Tier 1 Capital should be designed so that it is workable for instruments issued and held within groups of related entities in a financial group, including entities which are not resident in the same country.

## 4. Elaborating the (i) widely-held and (ii) traded exceptions

The Domestic Draft discusses exceptions for instruments which are widely-held [para 147] and for instruments which are traded [para 153]. The discussion in the Domestic Draft clearly shows the serious practical difficulties that would be involved for issuers (regardless of whether it is the primary rule or the secondary rule that has to be applied) to an instrument that is widely-held or traded: in which jurisdiction is the current holder resident and what is the current tax treatment in that jurisdiction, who does the issuer have to notify of changes to the domestic tax treatment of the issuer?

These problems are very real and should result in a recommendation for a blanket exception from these rules for instruments that are either widely-held *or* traded, or both (and *not* in a recommendation that issuing institutions set up and maintain elaborate systems to try to collect this information – *cf* para 156). The ABA supports both of these exceptions and hopes that more detail on their precise limits will be included in the final recommendations:

- The notion of "widely-held" should be defined using (i) a number of investors and the (ii) value of their holdings which (a) can be easily verified by the issuing institution and (b) can be determined based on its own records.

- Whether or not an instrument meets the "traded" test should be able to be determined at the time of issue, based on the characteristics of the instrument at that time and attach to the instrument for the remainder of its life. The alternative – a test which is dependent on evidence of actual trading occurring post-issue or can be attached and detached as circumstances change [*cf* para 157] – is unrealistic, may result in different outcomes in different years and place an excessive compliance burden on issuers. The term "tradable" may be better for this purpose.
- It should be prescribed that an instrument will satisfy the "traded" test if it is listed on an exchange.

## 5. Tier 2 Instruments

The regulatory requirement for Tier 2 Instruments to also include "non-viability triggers" has the potential to result in similar issues to those discussed above for Additional Tier 1 Capital. The recommendations made above around elaborating on the widely held and traded exceptions, or a specific exclusion for Additional Tier 1 Capital, should be extended to Tier 2 regulatory Capital.

## 6. Other comments

The Domestic Draft contemplates that some classes of instruments pose such low risk of abuse that they can be excluded from the scope of any new rules [paras 141 ff]. The Domestic Draft suggests this could be the case for instruments issued primarily to individuals or other retail investors (instruments held by closely-held companies and privately-held pension funds might be examples). Both of these possible exceptions should be expressed as clear recommendations.

This exclusion should, in fact, be much broader and apply to any portfolio holding, given that such investments would typically not enjoy a participation exemption or credit for foreign underlying tax. (The non-inclusion and related party requirements may reach this result, but an explicit portfolio holding exception would make that outcome clearer, and be simpler to operate.)

The final recommendations should also explicitly address the effects of CFC and PFIC rules. It makes little sense to insist that the tax law of the issuing country deny a deduction to the payer for a payment that is not included in income in the recipient's country if the amount is actually included in income in the issuer's country – as accumulated passive income or base company income – through the application of CFC or PFIC rules.

The Domestic Draft does not pay sufficient attention to the entirety of a country's tax system, especially the impact of withholding taxes. The description of a hybrid financial instrument refers to, "a payment which is ordinarily deductible under the domestic law of the payer's jurisdiction [and] not included in ordinary income under the domestic law of the payee's jurisdiction" [para 83 – our emphasis]. But in many countries (not affected by the EU Interest and Royalties Directive) the impact of a withholding tax on a deductible payment will significantly reduce the size of the benefit that appears by looking just at the amount not included in the recipient's country. For example, even without triggering an anti-hybrid rule, a deductible interest payment made by an Australian resident to a non-resident company would be liable to withholding tax of 10% of the gross cash flow under Australian domestic law (which would often not be affected by a treaty). This may turn out to be more than the tax that would be payable in the lender's country of residence if tax was imposed at local rates but on income reduced by expenses.

We note finally, but very importantly, that the Domestic Draft does not address the issue of transition and the commencement of any domestic law changes. It is always good practice to undertake tax reform on a prospective basis and we hope that the final recommendations will include a recommendation that countries apply their rules only to newly-issued instruments, or existing instruments which are varied in a material way after the commencement of the rules.

Yours sincerely,

Paul Stacey

May 2, 2014

# BEPS Action 2: Hybrid Mismatch Arrangements

Comments by the Banking and Finance Company Working Group on BEPS

## I. Introduction and Summary of Recommendations

These comments are being submitted to the OECD by the Banking and Finance Company Working Group on Base Erosion and Profit Shifting (BEPS), which consists of banks and finance companies conducting international business, in response to the public discussion draft titled *BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* (the "Draft").

Our main comments may be summarized as follows:

- The recommended anti-hybrid rules in the Draft are based on design principles that seem, in part, to be ill-suited to attaining the stated policy goal of preventing the use of hybrid mismatch arrangements to achieve BEPS outcomes. Specifically, adopting the design principles of comprehensiveness and automatic application has led to recommendations that would apply an anti-hybrid rule to transactions that are not tax-motivated, thereby creating unnecessary compliance burdens and potentially distortionary effects.

- We believe that a "bottom-up" approach to designing rules for hybrid financial instruments and transfers is the only practical approach. It does not seem possible to anticipate all of the potential transactions that should be excepted from a broad rule that would otherwise cover all hybrid financial instruments and transfers. We do not agree with the Draft's recommendation, however, that a bottom-up approach should result in rules that apply to all related-party hybrid instruments regardless of the circumstances.

- We strongly agree with the suggestion in section IV.E of the Draft that hybrid regulatory capital should be outside the scope of any recommended anti-hybrid rules. The hybrid financial instruments in this category are not used for BEPS purposes.

- The Draft should be revised to clarify that sale and repurchase transactions ("repos") entered into in the ordinary course of business by a financial institution are outside the scope of any recommended anti-hybrid rules, as they are secured

loans that do not give rise to BEPS concerns.

- We have concerns about the lack of clarity regarding the core question of how to determine whether an income item has been included in ordinary income for tax purposes by the recipient. Similarly, we are concerned about the open-ended nature of the definition of "financial instrument", which could lead to differing definitions in different jurisdictions.

## II. Mismatch between policy objective and design principles

The Draft sets forth a number of anti-hybrid recommendations, including a hybrid financial instrument rule (at paragraph 81), based on design principles which are stated in paragraph 27. These principles include standard tax policy goals such as clarity, administrability, and neutrality, in addition to more unusual concepts such as comprehensiveness and automatic application (as opposed to application based on an exercise of judgment). We have concerns about these latter two design principles, as they do not appear to be consistent with the objectives of the OECD and G20 regarding BEPS and hybrid mismatches.

The Background discussion on pages 4-5 (paragraphs 1-6) of the Draft indicates that the policy objective is to address "tax planning schemes involving hybrid mismatch arrangements" which are described on page 8 (paragraph 16) as "arrangements [that] incorporate techniques that exploit a difference in the characterization of an entity or arrangement under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes." It seems clear that the objective is to address transactions motivated by tax considerations, and not to address non-tax-motivated transactions.

This is supported by paragraph 22, which says "the focus of Action 2 is on arrangements that exploit differences … in order to achieve profit shifting and base erosion outcomes. Action 2 is not intended to capture all arrangements that have the effect of lowering the aggregate tax burden of the parties to an arrangement."

The design principles in paragraph 27, however, seem to be in conflict with the main objectives that are asserted earlier in the Draft. In particular, the design principles call for automatic application of comprehensive rules that operate to eliminate all mismatches. There is no mention of targeting the rules so that they apply only to mismatches that were deliberately achieved as part of a tax plan. Moreover, paragraph 32 states that there is no need for "a qualitative assessment of whether the arrangement has been used to erode the domestic tax base" of the country applying an anti-hybrid rule, because the OECD is recommending "a multilateral approach which applies the hybrid mismatch rule to any hybrid arrangement that has the effect of lowering the overall global tax rate of parties affected by the arrangement." However, this statement seems to contradict the statement in paragraph 22 noted above.

The Draft states in paragraph 28 that “the [anti-hybrid] rules are intended to drive taxpayers towards less complicated and more transparent tax structuring,” which implies that the hybrids subject to the rules are complicated and non-transparent. But at the same time the Draft recommends a comprehensive and automatic set of anti-hybrid rules that apply to any transaction that results in a tax mismatch, including common and straightforward transactions such as the issuance of redeemable preferred stock, if it is viewed as equity in the investor’s country and as debt in the issuer’s country.

The Discussion Draft does not provide a convincing rationale for a comprehensive, automatic set of anti-hybrid rules that apply regardless of whether a tax mismatch was intended. Instead, Paragraph 30 simply states that if the rules are not comprehensive, taxpayers will be able to avoid them. This does not explain why the rules should apply to transactions that do not give rise to policy concerns. Paragraph 32 says that if the rules are not automatic, they will be less efficient and consistent in their operation. Again, no reason is given for applying the rules to transactions not motivated by tax considerations.

Comprehensive, automatic rules could result in an unjustified disparity of tax treatment of similarly situated taxpayers based on a factor beyond the taxpayer’s control, i.e., a foreign jurisdiction’s characterization of a financial instrument or transfer for foreign tax purposes. Compliance and administrative burdens would be increased, not lessened, by the need to inquire into the foreign tax treatment of payments.

We note that the OECD’s discussion draft on BEPS Action 6 (preventing the granting of treaty benefits in inappropriate circumstances) recommended rules designed to apply to tax-motivated arrangements only. Although we had concerns about certain aspects of the recommendations in that discussion draft, it seemed that the OECD was appropriately making an effort to target the use of treaties for deliberate base erosion and profit shifting, which is consistent with the overall goals of the BEPS action plan. The recommendations on Action 2 (hybrid mismatch arrangements) should be similarly targeted.

The suggested anti-hybrid actions (ii), (iii), and (iv) in the BEPS Action Plan (reproduced in paragraph 8 of the Draft) seem to have been interpreted as mandatory instructions to issue corresponding recommendations regardless of whether the recommended rules are overbroad in their effect.

Our comments below will elaborate on how the recommendations can be tailored to apply more appropriately to the hybrid mismatches that give rise to policy concerns.

## III. Bottom-up versus top-down approach, and other scope issues

In order to best address concerns about the overly broad scope of the anti-hybrid recommendations in the Draft, a more targeted bottom-up approach should be used, rather than the top-down approach, in formulating the rules.

As noted in our comments above, the BEPS concern about hybrid mismatches is limited to tax planning arrangements. Therefore, a top-down approach involving a comprehensive rule with exceptions does not seem appropriate. (This point seems to be acknowledged in paragraphs 141 and 142 of the Draft.) A bottom-up approach that identifies objectionable hybrid mismatch arrangements with specificity is more fair and appropriate, primarily because, as is stated in paragraph 137, the bottom-up approach can limit the scope of the anti-hybrid rule to the transactions that give rise to BEPS concerns.

More specifically, a more targeted approach is embodied in the statement in paragraph 121(b) that an anti-hybrid rule would most appropriately apply to structured arrangements designed to produce a mismatch, and in our view factors (a) through (e) in paragraph 131 could properly be included as relevant factors to be considered in applying such a rule. (We assume that factor (a) in paragraph 131 is a single factor rather than multiple factors.) In addition, we would qualify factor (d) by adding the words "that have no independent business purpose" after "special-purpose vehicles." Additional factors that could be considered are whether the parties to the transaction are commonly controlled and whether the transaction was on arm's length terms.

We have some concerns, however, about the broad statement in paragraph 121(a) that an anti-hybrid rule should apply whenever the issuer and investor with respect to a financial instrument are related parties, including persons deemed to be acting in concert, without regard to other facts and circumstances that might show an absence of tax planning. Our concerns are heightened by the proposal in paragraph 128 to use a 10% ownership threshold to define related persons, supplemented by broad "acting in concert" rules that deem a person to own or control voting rights or equity interests owned by another if any of several relatively general conditions are considered to exist. These rules would unnecessarily create uncertainty and compliance burdens with respect to financial transactions between parties dealing at arm's length. At a minimum, a taxpayer that is considered related to the counterparty on a hybrid financial instrument should have the opportunity to rebut a presumption that an anti-hybrid rule is applicable. In addition, to support such a presumption, the common ownership threshold for related-party treatment should be "greater than 50%."

We support the Draft's proposal to take widely held instruments out of scope, but a top-down approach necessitates crafting of a definition of "widely held" that appears impossible to accomplish. A more targeted, bottom-up approach eliminates this very important design problem. We note that it does not appear to be possible to define "widely held" in a way that would be administrable in practice and lead to appropriate results. Debt instruments can be issued to a relatively small group of institutional investors who then sell part or all of the instruments to other investors over time. Obtaining information about the number of holders of a particular financial instrument and their tax treatment at any given time would be impractical. This practical consideration reinforces the conclusion that the bottom-up approach is the correct one.

Moreover, we have concerns about the suggestion in paragraph 150 that the exemption for widely-held instruments be limited to the issuer's side of the transaction, so that holders would be required to include a payment on a widely held instrument in taxable income if the issuer was entitled to a deduction.

It is hard to see a justification for this partial exemption in part because the tax policy principle of horizontal equity would appear to be violated under such an approach. Such an approach would mean that an investor in a widely held instrument issued by a foreign issuer would be taxed differently from a similarly situated investor resident in the same jurisdiction who had invested in an identical instrument issued by a domestic issuer, to the extent that, although both investors would normally receive a tax-exempt return under domestic law, one investor would be taxed under an anti-hybrid rule simply because the foreign issuer was able to claim a deduction for foreign tax purposes.

For example:

> *Taxpayer 1, a resident of Country A, invests in a widely held perpetual debt instrument issued by Fast Growth Co., a resident of Country A. Taxpayer 2, also a resident of Country A, invests in a similar widely held perpetual debt instrument issued by FGC plc, a resident of Country B. Country A treats each instrument as equity for tax purposes; Country B treats the instruments as debt and allows a deduction to FGC plc for interest paid thereon. Neither Fast Growth Co. nor FGC plc has any earnings and profits for the year in question. Taxpayer 1 has no taxable inclusion for payments received from Fast Growth Co., which are treated as a nondeductible return of capital under Country A law. If an anti-hybrid rule applied, Taxpayer 2 would have to include payments received from FGC plc in taxable income in Country A because the payments are deductible in Country B. (This example assumes that the terms of the instrument do not give any of the tax benefit of the deductions to Taxpayer 2, and that all of the parties are unrelated to each other.)*

Horizontal equity requires that Taxpayer 1 and Taxpayer 2 be treated the same way under Country A tax law with respect to payments received on their similar investments. There does not appear to be a policy justification for an anti-hybrid rule that would impose tax on Taxpayer 2 solely because deductions were available under foreign law to the unrelated foreign issuer of the widely held instrument held by Taxpayer 2. The same violation of horizontal equity would occur in Country B if FGC plc were denied a deduction based on a lack of income inclusion in Country A, while other Country B resident companies were able to deduct payments on similar instruments issued to investors resident in Country B.

Leaving aside the possibility of instruments issued into the capital markets as part of a structured hybrid mismatch arrangement (a possibility that is surely remote), there is no BEPS concern to be addressed in the case of debt instruments issued into the market. The holders of such instruments do not acquire them in order to obtain a tax benefit, and the issuers issue them for the purpose of raising capital.

## IV. Hybrid regulatory capital of financial institutions

The Draft acknowledges, in Section E, paragraph 158, that the treatment of bank hybrid regulatory capital is an important issue that must be taken into consideration in developing rules for the tax treatment of hybrid instruments and structures. While certain types of regulatory capital raised through instruments issued directly to the market would be out of scope under the top-down approach suggested in the Draft, and presumably would be out of scope if a bottom-up approach to identifying targeted hybrid instruments and structures were adopted, the movement of this capital down through a group into locally regulated entities, which is common practice in both the banking and insurance industries and is becoming the preference of regulators, would potentially be captured by the recommended rules for related-party arrangements. The Draft correctly raises issues and questions as to whether this movement of capital into subsidiaries, through the issuance of intra-group instruments, should be in scope given that it is driven by regulatory requirements. We believe for a variety of reasons that hybrid regulatory capital that is "pushed down" through a consolidated group into regulated subsidiaries should not be subject to anti-hybrid tax rules.

In considering the scope of potential anti-hybrid rules, HM Treasury has pointed out in its recent document setting out priorities for the BEPS project, "Tackling aggressive tax planning in the global economy" (March 2014), that "thought will also need to be given to the treatment of hybrid regulatory capital held by the financial sector, where the hybrid nature of the instrument is essentially imposed by the regulator rather than being chosen by the business. The concern would be the extent to which anti-mismatch rules might disincentivise regulated financial institutions from raising capital in more loss absorbing forms, an outcome which would be counter to regulatory objectives."

Following the financial crisis, the regulatory framework applicable to financial institutions has undergone significant change as regulators seek to protect creditors of such regulated entities and to ensure that regulated entities in distress can be satisfactorily resolved, without resorting to taxpayer support. The Basel Committee on Banking Supervision (BCBS) is responsible for developing international minimum standards on bank capital adequacy. The BCBS standards have developed over time, and Basel III is the third and most recent configuration of those standards. A key element is the requirement for regulated entities to hold adequate capital, and provision has been made for financial institutions to hold minimum levels and additional buffers of capital. As part of the minimum funds requirements, banks are required to hold 6% of their risk weighted assets in the form of Tier 1 capital, of which 1.5% may be held through Additional Tier 1 instruments (AT1).

The features of AT1 instruments are prescribed by the bank regulator and their issuance and repayment are subject to significant regulatory oversight. Due to their prescribed attributes, AT1 instruments have both debt and equity-like features, such as mandatory conversion to ordinary shares in the event of financial stress. Similarly, the European Union, in its revision of the capital requirements directive known as Capital

Requirements Directive IV (CRD IV), permits a percentage of bank Tier 1 capital to include such hybrid Tier 1 capital instruments. CRD IV includes stricter criteria for these new versions of AT1 capital so that they are sufficiently loss absorbing, and limits the amount of AT1 capital that an institution may use to satisfy its capital requirements. Among other things, CRD IV requires that all such instruments absorb losses by being written down, or converted into Common Equity Tier 1 instruments when the key measure of bank's solvency – the Common Equity Tier 1 capital ratio – falls below 5.125%.

While these instruments are relatively new – CRD IV went into effect only on January 1, 2014 -- it is emerging that the tax treatment of the instruments may differ from jurisdiction to jurisdiction due to their combination of debt and equity features. We believe, therefore, that it is absolutely necessary to have tax rules that do not interfere with the issuance of regulatory capital at the parent company level and that accommodate practices not only permitted but preferred by banking regulators to pass this capital down within the group to local country subsidiaries.

Regardless of whether final OECD anti-hybrid recommendations take a targeted bottom-up approach or a more broadly written top-down approach, AT1 instruments issued directly to the market would likely not be caught by either a related-party anti-hybrid rule or a broader carve out for "widely held" instruments. However, banking groups are facing increasing pressure from regulators around the world to issue capital centrally, from a "single point of entry," into the market, rather than have separate subsidiaries of a banking group each issue their own AT1 instruments into the market. Ultimately, in order for the capital to be pushed down into the subsidiaries, related party instruments will be necessary in order to maintain the attributes of the AT1 capital at the local subsidiary level.

*Intra-group hybrid regulatory capital instruments should be out of scope*

As noted in our comments in sections II and III, above, we believe any anti-hybrid recommendations should be properly focused on tax-motivated transactions and should not target all related-party transactions. A properly focused rule would ensure that the tax treatment should not be altered for genuine intra-group movements of regulatory capital. The need to address the treatment of regulatory capital in these comments is a reflection of the fact that the broad recommendations in paragraph 121 of the Draft are not properly targeted.

Paragraph 160 of the Draft states:

> "it is assumed for the purposes of discussion that AT1 instruments issued directly to the market are unlikely to be caught by either a related-party hybrid mismatch rule, or a more widely drafted rule that contains a specific carve out for 'widely-held' or 'traded' instruments. However, as a result of regulatory requirements, banks themselves are increasingly constrained in their ability to raise capital in this way. As part of a wider move towards a 'single point of entry' resolution, a number of regulators are encouraging banking groups domiciled in their

jurisdiction to issue all their loss absorbing capital at top holding company level and then pass this capital down through the group to the relevant subsidiaries."

In the accompanying Questions for Consultation, the Draft further identifies the tax issues that must be resolved in the context of hybrid mismatch arrangements in order to ensure that practices required by financial regulators are not impeded.

We believe that intra-group regulatory capital instruments should be made out of scope. The following policy considerations are critically important:

- For banks, the existence of the hybrid financial instrument is driven by regulatory requirements. As noted above, regulators of banking groups consider the capital adequacy of the consolidated group of entities. Accordingly, regulators are requiring capital issuances at the level of the group's parent entity.

- Therefore, the necessity of the intra-group hybrid capital instrument is driven by the fact that the local level subsidiary often cannot issue, or is disadvantaged by issuing, capital-related instruments to the market itself because the regulator of the group requires that the AT1 instrument be issued "at the top of the house." If the local entity does issue directly to the market, that capital may be discounted or disregarded for consolidated regulatory purposes. Hybrid regulatory capital is also distinguishable from hybrid debt that other non-financial companies may issue because any redemptions or movement out of the local subsidiary will be subject to regulatory approvals. The existence of AT1 capital instruments, and their approval by regulators, is relatively new, and the tax treatment in jurisdictions around the world is evolving. Therefore, the OECD should prescribe the most flexible approach possible to accommodate the capital needs of banks and the requirements of their regulators. We recommend that the OECD recognize that the tax treatment should accommodate regulatory rules in this area.

- The tax treatment is further complicated due to the typical operation by banks through branches in different jurisdictions. There is no standard rule among countries under which capital is allocated to branches for tax purposes, further complicating any effort to set an international standard for the tax treatment of regulatory capital that is pushed down through a banking group in order to address tax mismatches from jurisdiction to jurisdiction.

- A banking group would obviously be economically disadvantaged if it were to be prohibited from claiming a tax deduction at a local subsidiary level under a related party anti-hybrid rule. It would also be placed at a competitive disadvantage in comparison to locally based banks whose widely held AT1 instruments would be out of scope of the rule due to the "widely held" carve out. A bank issuing hybrid regulatory capital indirectly to the market through its holding companies should be treated on equal terms with a bank that issues such instruments directly to the market.

- Other industries may argue that they too should not be penalized by anti-hybrid rules that apply to related-party transactions because they also need to raise capital as efficiently and inexpensively as possible. However, the regulatory overlay for banks is the essential factor that drives our request that such related-party AT1 instruments be taken out of scope for banks. Moreover, this type of instrument is limited by regulation as counting towards good Tier 1 capital, whereas such limits do not apply for other commercial enterprises. (We note that, in any case, a rule properly targeted at tax-motivated transactions would address the concerns of taxpayers in other industries who may be caught by an overbroad anti-hybrid rule.)

- Finally, it is also important to note that the issuance of intra-group hybrid regulatory capital instruments results in only one net tax deduction for the group; in other words, deductions do not multiply down through the chain of subsidiaries.

As noted above, the amount of hybrid regulatory capital that a regulated financial institution can have is limited by both the regulator of the group and the local regulator. If there is concern among the OECD/G20 members regarding a carve-out for all hybrid regulatory capital, we suggest that a carve-out for banks' hybrid regulatory capital instruments could be subject to an overall cap equal to the amount of hybrid regulatory capital issued by the group to external investors. The allocation of this amount to regulated entities within the group should be given further consideration.

## V. Repo transactions

We are concerned that the examples involving sale and repurchase arrangements ("repos") in paragraphs 66-80 and paragraphs 262-271 of the Draft may create a presumption that repo transactions are only used for tax planning purposes. In fact, repos are secured lending arrangements entered into in the ordinary course of business on a daily basis by banks and finance companies for non-tax reasons.

The examples in the Draft that involve repos are structured transactions designed to achieve a BEPS result. While such transactions are an appropriate target of Action 2 of the BEPS Action Plan, the vast bulk of repos are done for financing purposes and do not generally raise hybridity concerns. Repos are very common in the financial services industry and are considered in all financial center jurisdictions to be secured loans that generate interest income and expense. Instead of a lender lending cash secured by collateral, repos involve the sale of securities together with an agreement for the seller to later buy the securities back. The repurchase price is usually greater than the original selling price with the difference effectively being interest (sometimes called the *repo rate)* and treated as such for tax purposes. The party that originally buys the securities – i.e., provides the cash – is effectively the lender. The original seller – i.e., the party receiving the cash -- is effectively the borrower, using the securities

transferred as collateral for a secured cash loan. There may be jurisdictions where the tax law is unclear as to whether repos are treated for tax purposes as sales transactions rather than a secured financing, with the result that there can be the possibility that a repo would fall within the definition of a hybrid transfer. The OECD should explicitly acknowledge the fact that repos are a normal form of secured lending in the ordinary course of a financial institution's business and are not within the scope of the anti-hybrid rules unless they are part of a structured hybrid mismatch arrangement.

It is worth noting that similar considerations are relevant to stock lending transactions, which are normally done for non-tax reasons and may be characterized for tax purposes as loans in some jurisdictions and as sales in other jurisdictions.

## VI. Definition of "dividend exemption" and "inclusion in ordinary income"

Clarification is needed as to whether the availability of an indirect foreign tax credit is considered equivalent to a dividend exemption.

The Draft seems to indicate that, if a dividend is received by a taxpayer who must include the dividend in ordinary income, the dividend is nevertheless not considered includible in ordinary income for purposes of the proposed hybrid financial instrument rules to the extent that the dividend carries an entitlement to an indirect foreign tax credit (see paragraphs 62, 94 and 108). However, in paragraph 85, it appears that a dividend exemption is *not* considered to be the same as other forms of double tax relief relating to dividends, although this could change ("[F]urther consideration could be given to whether a recommendation in respect of the dividend exemption should apply to other types of double tax relief granted for dividends…"). There are mixed messages here, causing confusion.

It is not at all clear how a rule equating entitlement to an indirect foreign tax credit with a dividend exemption to the extent that the credit was available would work in a case where (as in the United States and perhaps in other countries with worldwide tax systems) the taxpayer's foreign tax credit is calculated not on an item-by-item basis but rather on the basis of a pool of foreign-source income blending numerous different items of income and related foreign tax expense, and the credit offsets a portion of the taxpayer's tax liability with respect to all of the taxable income of the taxpayer.

## VII. Definition of "financial instrument"

The Draft also leaves the definition of "financial instrument" unclear. In paragraph 81, recommendation (d) provides:

> "The kinds of financial instruments caught by the rule should be left to domestic law but … should at least include anything that is treated as a debt or equity under the laws of the jurisdiction applying the rule. The definition

> should also include, where appropriate, arrangements that taxpayers use as alternatives to debt and equity."

This open-ended formulation may lead countries to adopt rules that are similarly open-ended in scope, creating uncertainty as to what the rules apply to. This formulation also creates the very real possibility that taxpayers will face inconsistent and potentially conflicting definitions from jurisdiction to jurisdiction. We suggest that the OECD's recommendation should indicate the need for clarity regarding what is covered, along the lines of what is said in paragraph 105 ("The rule should define the arrangements that are within scope.") but with a reference to specificity.

The Chemical Company

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Achim Pross
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May 2, 2014
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Dear Sir/Madam,

We appreciate the opportunity to provide the OECD with comments on the Discussion Draft “Neutralise the Effects of Hybrid Mismatch Arrangements” as published on March 19, 2014.

BASF is a multinational group operating in more than 80 countries with business activities comprising 14 operating divisions and almost 400 production sites and with high volumes of complex transaction flows within the group, including several joint ventures with third parties.

It is generally accepted that governments worldwide are competing in different ways with the objective to attract and encourage both internal and external investment with a view to achieving sustainable economic growth and rising living standards. With this policy objective in mind, governments may promote wide ranging policies designed among others to improve infrastructure, knowledge level, competitiveness of labour costs, etc., but also to grant economic incentives to investors, where tax incentives tend to have an important role. In this context, tax competition seems to be acceptable if incentives offered are not overly aggressive and do not have a harmful and distorting impact on other countries. It is implicit that the effect of these non-harmful tax incentives is that they result in an intended lower-taxation or even non-taxation, e.g. tax holidays for investment, investment grants, R&D tax credits etc. Every country has its own unique tax system, often very sophisticated and well thought through, but no two tax systems are likely to be identical. The natural consequence therefore of not having a global harmonised tax system is that a non-intended lower taxation or even double non-taxation is quite possible. Moreover, the mere fact that different countries have different tax rates, could also be seen as a mismatch between countries resulting in tax arbitrage.

We believe that the OECD should distinguish situations of double non-taxation between those that are intended natural consequence of differing, but equally valid, tax systems and those that are non-intended mismatch situations. Restrictions on intended mismatches which have their basis in local legislation and are not considered harmful should not be addressed by the OECD. The OECD should focus solely on non-intended mismatches leading to a double non-taxation as a result of the application of tax treaties

only. Intended differences should be accepted as they are an expression of sovereignty of countries. The fight against harmful tax competition, which BASF fully supports, should not though have within its scope the fight against any and all tax competition. In our view, a continued debate about what is harmful and/or intended double taxation and what is not would be a useful starting point in order to define the parameters for preventing double non-taxation.

Besides this more general view on the initiative to neutralize the effects of hybrid mismatches, we will hereinafter give you an overview of our comments on the content of the report. We expect that various difficulties will arise, mainly caused by the fact that the proposed recommendations to domestic law will in a lot of cases not align with principles in different countries which are deeply embedded in their tax regimes and jurisprudence, which we assume will lead to inconsistent implementation by the different countries. Thus the OECD may not reach its intended goal to avoid both double taxation as well as double non-taxation. The desire to eliminate double non-taxation should not lead to a creation of double taxation and more uncertainty for tax payers as potentially, as a likely result of the debate, some countries might introduce general treaty override rules in their local legislation.

Finally, we see significant room for conflict and overlap concerning various other BEPS action plan initiatives, including the points around treaty abuse, CFC rules, as well as interest deduction rules. In particular separate interest deduction limitations will again increase the risk of a multiple deduction denials [under one or more different local tax rules or BEPS action plan initiatives] in a chain of transactions in many cases, thereby resulting in economic double taxation.

## 1. Sovereignty of nations

BASF is of the opinion that it is not the role of the OECD to provide guidance to countries to change their domestic legislation. The domestic recommendations of the Discussion Draft conflict with the sovereignty of nations on national taxation. We do not expect countries around the world to be willing to give up their sovereignty, especially not in cases where local incentives are intended.

The recommendations can have a huge impact on strongly embedded principles in local law and jurisprudence. In a country with a general participation exemption method for example, the new principles can conflict with the principles behind that method. The denial of the participation exemption on hybrid financial instruments which are in principle treated as equity from a local tax perspective, would deny the principles and the background of the rules which such a country believes are the backbone of their tax system. These countries very often already have a sophisticated anti-abuse doctrine integrated in their local tax law, based on their own tax principles. For example, a participation exemption may be linked to a rule of non-deductibility of costs relating to the participation. By denying the exemption, further changes in local law would need to occur to eliminate a situation of being taxed on the participation income but being denied any corresponding expenses along with the introduction of a credit system to avoid an economic double taxation.

To be successful in neutralizing the effects of hybrid mismatches between different countries we therefore think that the OECD should focus on treaty issues and propose changes to the model convention as for example described in the Discussion Draft on Treaty Issues related to Hybrid Mismatch Arrangements as well as in the Discussion Draft regarding BEPS action 6.

**2. Inconsistent implementation and interpretation**

As described above we do not think that the OECD should require legislative changes to local legislation. At a practical level, the recommendations for domestic laws, in order to prevent hybrid mismatches, could only work if every jurisdiction in the world would apply exactly the same rules in their local legislation and every jurisdiction around the world would interpret this legislation and associated definitions in the same way. Realistically, we do not expect this to be the case. Our expectation is that, not only will some countries be reluctant to implement the proposed rules at all, those countries which are willing to implement the rules, will need to implement the rules in line with the existing domestic legal framework and uniformity around the world is, in our view, an unrealistic expectation. Importantly, countries which do not implement the rules may profit to the detriment of those which implement the rules.

Most tax systems have detailed, well thought through definitions existing already. As an example we refer to the term “related persons”, on which in different countries several anti-abuse rules are based today. For these kinds of definitions we feel that it will be hard to align all countries.

The linking rules presented seem to eliminate the mismatch without firstly, indicating what that means for treaty application purposes, and secondly, considering whether a jurisdiction has actually lost tax revenue under the arrangement. In practice we assume that existing domestic law will be leading in implementing the rules, consequently leading to inconsistent results which might lead to double taxation e.g. for a country that usually applies tax exempt schemes, it will also need to provide sufficient tax credit possibilities if they include mismatch income in their tax base.

**3. Complexity**

It is not always clear how a certain transaction has to be treated locally. Now assume a hybrid financial instrument being issued by country A to country B, both having implemented the linking rules as proposed. It might be very well possible, that the tax treatment of the instrument is unclear in country A, or even worse, in both country A and country B. Based on the linking rules, country B should deny the participation exemption method if the payment were deductible in country A, but how can Country B apply the linking rules if country A does not even know yet how to treat the financial instrument and if they don’t know yet themselves whether or not the local participation exemption method is applicable in Country B. It is likely in our view that in such cases both countries may look to safeguard their own tax position, with a possible double taxation as a consequence.

Besides the above complexity we would like to point out the difficulties of the so called imported mismatch. This would mean that tax administrations in the importing country need to have knowledge about the tax systems of not only their own country, but also about the tax systems in two other countries. This in itself appears to be an unrealistic expectation of, and burden on, the tax administrations (or the tax payer in jurisdictions where the burden of proof lies initially with the tax payer).

**4. Application to non-related parties**

We believe that any mismatch rules should not apply to any transactions between non-related parties. Hybrid instruments are widely used on capital markets and not only for tax optimisation purposes. In non-related party transactions it is often impossible to obtain information regarding the treatment of the instrument in the hands of an unrelated party. The complexity and administrative burden of obtaining such information would surely outweigh any risk of non-taxation which would in any case not be motivated by base erosion and profit shifting.

**5. Overall conclusion**

We are of the opinion that the absence of a harmonized global tax system means that the OECD should not promote the general idea of introducing local rules in a country inconsistent with their general tax system that allow a deviating tax treatment if another country provides a tax incentive. Instead we would recommend to limit the OECD initiatives to changes in the OECD model convention in order to try and avoid hybrid mismatches as well as improve the exchange of information between countries in order to assure that countries involved are aware of possible hybrid mismatches. This exchange of information should assist those countries to response appropriately based on their local law and jurisprudence as well as the treaty between countries.

There is a significant risk of inconsistent implementation and interpretation in different countries which will lead to a continuation of hybrid mismatches and/or uncertainties for tax payers. We therefore do not think that the design principle of being comprehensive will be met in practice. There should be very clear guidance on definitions and a requirement for consistent interpretation to be implemented by all countries. If not, hybrid mismatches will keep on existing. We believe though, that countries will not accept such consistent interpretation because of the consequent complications and disruption of existing law.

We advise to provide for a transition rule or a rule that respects existing situations.

We hope that our comments are useful. Please feel free to contact us with any questions you may have on the above.

Yours sincerely,

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*2nd May 2014*



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**BDI-Comments on OECD Discussion Drafts "Neutralize the Effects of Hybrid Mismatch Arrangements"**

Dear Sir or Madam,

BDI* refers to the OECD Discussion Drafts "Neutralize the Effects of Hybrid Mismatch Arrangements – Recommendation for Domestic Laws" and "Neutralize the Effects of Hybrid Mismatch Arrangements – Treaty Issues" both issued on 19th March 2014. We would like to thank you for the possibility to provide our comments that allow us to engage with you on these important issues.

The BDI basically supports the OECD`s approach to tackle cases of double non-taxation by neutralizing the effects of hybrid mismatch arrangements, as it is widely recognized that hybrid instruments and hybrid entities might give rise to intended "double non-taxation", "double deduction" and "long-term deferral" in some cases.

Before commenting on the specific provisions we would like to outline some preliminary thoughts.

- **Freedom of selecting a certain legal form or financing instrument**

  It needs to be ensured that any approach to tackle intended hybrid mismatch arrangements shall not affect MNE´s freedom of selecting a certain legal form or its freedom of financing. As long as the decision

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* BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 37 sector associations and represents over 100,000 large, medium-sized and small enterprises with more than eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related service.

for a certain hybrid financial instrument or hybrid entity respectively, is determined by legitimate business reasons, neutrality needs to be kept. Rules should not be tightened to the detriment of all taxpayers. Thus, only cases of obvious abuse should be in the target. A way forward is to align rules among countries in order to avoid double non-taxation but also double taxation due to mismatches between countries.

· **Complexity**

It is important to underline that hybrid mismatch arrangements are the result of classification differences between the tax regimes of different jurisdictions. Thus we support the approach to neutralize the effects of such mismatches without addressing the financial and entity structures themselves.

Nevertheless we believe that base erosion and profit shifting cases are much more complex than the Draft currently outlines. The difficulty to determine cases that shall be tackled is additionally hampered by the fact that there is barely any data available. The OECD, indeed, undertook a review with a number of countries (including Germany) to identify examples of tax planning schemes that include hybrid mismatch arrangements resulting in the “Hybrids Report” published in 2012. The conclusion was that there is a risk for the collective tax base of countries, though it is very difficult if not impossible to determine the individual loss of tax revenue.

This causes a risk of addressing not only harmful tax practices that really put the tax base of countries at risk and threaten the competitiveness but also interfere in genuine business models that are not targeting at tax benefits due to hybrid mismatch arrangements.

For those reasons we suggest to undertake a detailed impact assessment in order to find a much more focused solution.

· **Administrative burdens**

Finally, we would like to express our concern, that the proposed changes may cause additional administrative burden.

As the arrangements described first of all apply to transactions usually made between related businesses it is essential that those companies do not have to check whether there is a risk for hybrid mismatches in each and every cross border transaction. Not every cross border transaction that results in a double-non-taxation is a matter of intentional and purposive base erosion and profit shifting.

Furthermore, we would like to take the chance to provide some comments on a specific issue.

· **Linking rules**

According to the proposed domestic law provisions the Discussion Draft recommends to introduce rules where the tax treatment in one country depends on the treatment in another country, so called “linking rules”. This includes a primary rule to apply whenever a mismatch arises (e.g. deduction without inclusion) and a secondary or defensive rule to apply in circumstances where the primary rule does not apply (e.g. prescribing that the income should be included in the payee's taxable income).

As each linking rule has its own information requirements, we expect many upcoming discussions regarding the ultimate tax treatment of income and the application in practice, including but not limited to different principles of involved jurisdictions. The ability of tax authorities and taxpayers to obtain sufficient information to conclude whether a structure falls within the definition of a hybrid mismatch arrangement will vary depending on a number of different factors (i.e. whether the counterparty is a related or a third party). This will lead to a significant increase of compliance and administrative costs especially for multinational companies, by introducing a duty to provide documentation of each cross-border intercompany transaction in two or more jurisdictions.

At the same time the risk of double taxation must be limited which is inherent to the proposed rules. In our view applying rules mechanically bears the risk of double taxation what is also seen by the OECD but can in our view not be avoided. This risk of double taxation becomes quite obvious when primary rules shall apply to hybrid financial instruments without taking into account CFC taxation at the recipient’s investor level.

Therefore, it should be considered to limit the application of the linking rules to related party transactions or to include an “intention or purpose test”. Unrelated party transactions generally do not bear a risk of a hybrid mismatch and are not targeting at tax benefits from mismatch arrangements.

It has been observed that exemptions for widely-held or traded instruments are discussed. However, the rules still seem to affect regular and commonly used financing measures, even if widely-held and traded, since also for the latter no clear exemptions are provided. Therefore, widely-held and traded convertible bonds or long term- and subordinated debt with characteristics of equity would potentially still be in the scope of the linking rules. However, those financing measures are in practice used to improve the equity ratios from an accounting/rating perspective rather than to make use of mismatches for tax purposes. In case of widely-held instruments it would be impractical for issuers of such instruments to collect the necessary in-

formation regarding (unknown) holders to comply with the primary rules.

Finally, in this regard, it is important to take into account the EU's recent proposal to amend the Parent Subsidiary Directive for hybrid instruments, as the EU proposal foresees taxation in the hands of the payee if the payment is deductible for the payer and thus applying the secondary and not the primary rule. Thus a coordinated effort is important.

Yours faithfully,

Berthold Welling

Katja Kallert

**BEPS MONITORING GROUP**

**Neutralising the Effects of Hybid Mismatch Arrangements**

This response is submitted by the BEPS Monitoring Group (BMG). The BMG is a group of specialists on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Tax Justice Network, Christian Aid, Action Aid, Oxfam, Tax Research UK. This response has not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This response has been prepared by Erika Barros Sierra, Jeffery Kadet, Francis Weyzig, Tomas Balco and Sol Picciotto , with comments from other members of the Group.

We welcome the opportunity to comment on the Consultation Document on BEPS Action Plan point 2, *Neutralise the Effects of Hybrid Mismatch Arrangements*, and the Related Note on *Tax Treaty Aspects of Hybrid Mismatches*, published by the OECD on 19th March 2014.

We will begin with some general comments, and then address some (but not all) of the specific questions posed in the Discussion Drafts.

## 1. General Comments

The problem of hybrid mismatch arrangements (HMAs) is probably the most technical and potentially complex issue to be addressed in the BEPS Action Plan, and hence one that might be neglected by those not closely involved. In our view, this would be a mistake, as we consider that it has as much importance as any of the BEPS issues. We commend the OECD for having produced a technically sophisticated analysis and proposed solutions which are carefully and elegantly designed.

However, in our view it is important first to take an overview of the causes of the problem before evaluating these proposals.

As we have pointed out in our other papers, the underlying cause of the problems of BEPS is the `separate entity' principle in tax treaties. It is this which not only allows but encourages multinational corporate groups to develop complex structures using entities in suitable jurisdictions to hold assets and route payment flows in ways which minimize their overall global tax exposure and achieve double non-taxation, all of which is now described as base erosion and profit shifting. Many of the proposals now being considered in the BEPS project, including these relating to hybrids, attempt to counteract these techniques by overriding the separate entity principle, but only in specifically defined circumstances. Hence, they can at best hope to provide only temporary palliatives to a system which desperately needs a more fundamental cure.

The tax treaty rules devised in 1928 aimed mainly to deal with portfolio investment, the then dominant form of international capital flows. They allocated to the country of residence of the investor the right to tax the income from foreign investment (interest, dividends), while the country where a business is located could tax its profits. This was adapted to deal with foreign direct investment (FDI) by multinational corporations (MNCs), by the `separate entity' principle, which treats the affiliates of a multinational corporate group in each country as if they were independent. This assumes that the Parent company is in reality an investor, and that its foreign subsidiaries and branches (Permanent Establishments – PEs) are independently and locally managed, and make payments to the Parent of interest on loans and

dividends on equity capital contributions that are in the nature of arm's length investments seeking merely a financial return.

This no longer has any basis in reality. Since at least the 1950s, MNCs began to raise and allocate capital for their various operations worldwide in an integrated manner. Since the 1960s, and especially after the liberalization of financial flows and markets in the 1980s, they have raised capital on global financial markets, using the `offshore' system, which greatly reduces their cost of capital. Since the 1990s, investment banks and other tax planners have devoted enormous resources to devising complex structured financing arrangements, which reduce the cost of capital even more. Many of these arrangements are tax driven, i.e. primarily designed to minimize tax. Central among these techniques is the use of hybrid mismatches.

Through their in-house tax group and outside tax and legal advisors, MNCs create a complex network of legal entities and a convoluted web of intra-firm financing and other contractual arrangements. Since some of our members have been tax advisers, we know that taxation is the primary (though not the only) factor in deciding the form of legal entity, place of formation, and residence of legal entities. The use of hybrid entities is generally a deliberate device used in tax `planning' for the sole purpose of achieving BEPS. The choice of financial structure and design of transactions may be affected by other regulatory concerns, but here again tax exposure is crucial. The point of course is that each country's tax authority can only see and tax the entity or entities that the taxpayer has consciously and carefully constructed to be seen by that tax authority. Through all the planned inter-company transactions and agreements, the taxpayer has defined what assets, activities and risks will be within each legal entity. This is a stacked deck. The tax authorities only see what the taxpayer (the MNC) wants them to see. The respect that is given under current tax rules to each legal entity, and its form as viewed under national laws, is at the heart of this situation.

These various techniques exploit inadequate or ineffective coordination of tax rules between states, all of which are viewing each entity as if it were a truly independent legal person. From this perspective the problem seems to be caused by `loopholes' between national laws, and the BEPS project proposes to resolve it by patching up existing rules. However, although there are disjunctures between national laws, they become `loopholes' as a result of their deliberate exploitation for tax avoidance purposes. Under the combination of the territorial and deferral taxation system which most countries now employ, and existing accounting rules, tax savings from BEPS can be transformed into higher share prices and higher executive pay (due to equity-based compensation). This creates a strong motivation for MNC managements to push BEPS to whatever limit the laws allow. As long as this motivation remains, strong BEPS efforts will continue.

For these reasons, even if the rules are patched up by states, the separate entity principle will continue to drive tax planning. Hence, this approach can only hope to be effective with much closer and continuous coordination between states. In our view, the current proposals on HMAs demonstrate this. Although they are put forward as proposals for changes only to domestic tax laws, on closer examination it is clear that they will need to be closely coordinated. We discuss this further below.

In our view, a much more effective approach would be the replacement of the `separate entity' principle with a `unitary' approach to multinational corporate groups. This does not require a radical shift to a fully-fledged unitary taxation system with apportionment based on pre-fixed formulas. This should, however, be the long-term aim, beginning now with a clear recognition of the need for a unitary approach. Indeed, this is implicit in the mandate to the

OECD from the G20 world leaders, that reform of international tax rules should ensure that firms are taxed `where economic activities take place and value is created'.

The financial structures of MNCs are the source of a large proportion of the problems of BEPS. Adopting a unitary approach could provide a comprehensive solution not only to HMAs, but also to other problems, notably base erosion via interest payments (Action Point 4), and transfer pricing problems of allocation of capital (Action Point 9). OECD states have used various forms of proportionate allocation of joint costs, including financing costs. In our view, the BEPS project should build on and refine these. Such an approach would recognise the economic reality that the MNC operates as a unitary firm, and simply eliminate all the effects of the artificial corporate structures and contractual arrangements, including hybrids. This would provide the basis for a solution which would be more comprehensive, simpler, clearer, and easier to administer.

Another version of a unitary approach would be for countries that are home-countries of major MNCs to abandon their territorial and deferral taxation systems and adopt a full-inclusion approach. This could be accomplished either through implementing a new taxation system, or much more simply by merely strengthening considerably the CFC rules already found in these countries. This strengthening would be accomplished through inclusion in the home-country tax base of any profits in PEs or foreign subsidiaries that have been subjected to a tax rate that is less than the home country's statutory rate. The foreign tax credit mechanisms that already exist in these countries would prevent double taxation.

The alternative chosen by the OECD will result in the elaboration of complex rules, attempting to deal with different aspects of the problem. This can clearly be seen from the proposals on HMAs, which entail intricate and detailed rules, in a system designed to be interactive. The response of tax planners will undoubtedly be to devise increasingly complex structures aiming to avoid those rules. Tax rules, like any regulatory arrangements, can only be effective on a sustainable basis if they work with the grain of the economic motivations of the persons whose conduct is being regulated, and not against them. The `separate entity' principle creates perverse economic incentives which will continue to drive the creation of complex structures and use of elaborate transactions exploiting differences between national laws. The only effective way to end this pointless and wasteful game is to deal with the root of the problem, the strong motivation for BEPS created by the separate entity principle.

## 2. Responses to the Consultation Document

### 2.1 The Design of Hybrid Mismatch Rules

*Are the objectives and design principles of the hybrid mismatch arrangements clear?*

*If further clarification is required, then where is this required and how could it best be provided?*

**Our comments**

The proposals put forward for dealing with hybrids take the form of suggested changes in national tax rules. It seems therefore that they are entirely a matter for each state. However, the Design Principles of the proposals (para. 27) make it clear that what is needed and envisaged is a `comprehensive' solution, which would `avoid double taxation through rule co-ordination'. Indeed, there are several mentions of `the advantages of dealing with hybrid mismatch arrangements on a multilateral and coordinated basis' (e.g. paras. 44, 47).

Thus, it seems that widespread and coordinated adoption of any rules designed to neutralise HMAs is essential. For the 'domestic approach' which the Draft on HMAs seems to be

suggesting to be effective, countries need to adopt parallel and consistent rules, using a common model and neutral language, adjusted to their particular situations. To make it less appealing for tax planners to devise strategies that involve the use of hybrids, a significant number of countries would need to have *harmonious* and *coordinated* HMA rules.

Hence, our response to these two questions is:

**How is it intended to achieve this comprehensive solution, and what multilateral and coordinated basis is envisaged?**

The proposals are put forward in terms of primary rules and secondary rules, which in a sense seem to be reciprocal, but it is not made clear how this would be articulated. How would the system work if one or more major states did not enact appropriate domestic rules as envisaged in the proposal? Perhaps the intention is to provide coordination through the possible multilateral convention which is being investigated (Action 15). However, even this would be binding only on and between the states which ratify it, and accept the particular provisions. Without such a formal framework, it is not easy to see how coordination could be achieved. It also raises a host of questions about the multilateral instrument, in particular whether it would be open to all states, including non-G20 members.

Even with a formal framework, there would be a need for continuing coordination to monitor implementation of the proposed system. Without this, the danger would be either under-enforcement, in which case BEPS would continue, or over-enforcement resulting in conflicts. Perhaps the intention is to deal with these issues through the Mutual Agreement Procedure (MAP), which the intention is to strengthen (Action 14). Yet, as OECD data on the MAP demonstrate, tax authorities have been already been unable to cope adequately with the growth of MAP requests in recent years, leading to an average time for resolution of over two years.

### 2.2. Hybrid Financial Instruments and Transfers

*Is it clear what elements need to be present in order for the rules neutralising hybrid financial instruments or hybrid transfers to apply?*

**Our comments**

We support the view that a hybrid rule should be intended to act automatically whenever a payment comes across the border having been deducted at the paying end, without having to prove a tax avoidance motive.

*Is the outcome of the rules' operation clear?*

*Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?*

**Our Comments**

In our view there are already some arrangements that do not seem to be caught by the proposals, others could be devised, and this is very likely to happen. A case in point is Belgium's notional interest deduction regime. This is used by many multinationals, which set up an entity in Belgium to provide loans to subsidiaries around the world. The assets of the entity consist of group loans, and the entity is financed with equity. The notional interest deduction system provides an allowance for corporate equity, that is, a deduction for the normal return on the book value of equity to reduce the difference in tax treatment between debt and equity. In 2013, the deduction rate was 3% for large companies. The deduction is available regardless of whether the entity pays out dividends. The result is that the intra-

group interest income earned by the entity in Belgium is effectively taxed at a low rate or not taxed at all. This notional interest deduction is not a special regime, it applies to all companies, including small domestic ones. For purely domestic companies, without foreign assets or foreign owners, the notional interest deduction does not result in mismatches. Hence it is unlikely to be considered a harmful tax practice. It seems to us that these proposals would not cover this arrangement, because the mismatch arises even if the entity in Belgium pays no dividend. However, it is essentially still a hybrid mismatch issue because one country allows a deduction whereas the other does not tax the income.

It should also be borne in mind that these proposals target only a specific aspect of BEPS structures. They will not deal with back-to-back arrangements, in which the receiving entity pays on the bulk of receipts to escape taxation in the intermediary country. Further extensive proposals will be necessary, under BEPS Action Plan point 4 to provide for limitation of deductions for payments to related entities not only of interest but also royalties and fees, and to deal with rental and leasing arrangements, which similarly exploit differences in treatment of financial, operating and hire-purchase leasing arrangements.

Adopting a unitary approach as we suggest, e.g. by proportionate deduction of financing and other joint costs such as R&D, would provide a more comprehensive solution which would be much easier to administer, especially for developing countries.

*This document sets out two possible approaches to drafting a scoping rule and summarises the possible advantages and disadvantages. Are the advantages and disadvantages accurately described and are there any other advantages and disadvantages of the two approaches?*

a. *What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration?*

**Our comments:**

We believe this problem requires a top-down approach. One of the main barriers to international cooperation is the fragmented approach to taxation and the wide range of rules and measures devised to address tax issues across the globe. We believe that in order to effectively neutralise the effect of HMAs it is essential to adopt simple and comprehensive solutions that reduce the ability of taxpayers to exploit loopholes that would inevitably arise with a bottom-up approach.

A ‘bottom-up’ approach would face tax authorities with the challenge of having to keep up with the ‘creativity’ that characterizes the tax planning industry. This approach, based on rules to deny non-inclusion/deduction/exemption/tax credit only in specific situations, would simply encourage the design of much more elaborate HMAs in order to circumvent the rules. In addition, rules designed under this approach would require constant monitoring to ensure proper application. Resolving the arbitrage questions raised by hybrid payments, entities, and transfers is easier said than done. The complexity comes from attempts to narrow the range of transactions covered, which is why we recommend a top-down approach.

Nevertheless, it could be helpful to include specific examples as illustrations of how the general rules are intended to operate, in the Commentary to the treaty. This is a familiar technique, which in our view overcomes the apparent dilemma between inductive or deductive approaches to rule-making.

*1.1.This part includes a number of examples:*

a. *What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties position?*

b. *In this context are there any examples or situations that are more problematic than others? If so please explain why problems arise and what constraints or restrictions the parties might face in obtaining relevant information on the treatment of the counterparty?*

c. *To the extent that there are difficulties, do these apply equally to both the holder and issuer in the context of hybrid financial instruments?*

d. *Are there any other situations or examples, not covered here that give rise to difficulties? In particular are there any specific problems for regulated businesses (see also Q. 8 below)?*

*1.2. What definition could be used to capture the concept of widely-held or regularly traded whilst also addressing concerns that any exemption should not be available to related parties, parties acting in concert or parties to a structured arrangement (i.e. an arrangement designed to obtain the benefit of a mismatch).*

*1.3. If the rule exempted certain traded instruments then how could it be drafted so that it still applied to structured arrangements?*

*1.4. In relation to regulatory capital*

a. *What are the regulatory requirements for banks' to issue/manage capital at top holding company level, and what arrangements are used to pass this down the group? For example, what use is made of identical and traceable instruments and under what conditions would the arrangement be funded by a market issuance at top holding company level?*

b. *Are special provisions needed to create parity between a banking group issuing hybrid regulatory capital indirectly to the market through its holding companies and a banking group (or another industry group) issuing hybrid regulatory capital directly to the market?*

c. *Are hybrid regulatory capital instruments sufficiently different as to justify a full carve-out from hybrid mismatch rules? Are there inherent safeguards in place against the use of these instruments for tax-planning purposes or what safeguards could be introduced to ensure that any exemption from the general hybrid mismatch rules could not be abused?*

**Our comments**

In our view, the difficulties which are evident here result from attempting to deal with HMAs while still upholding the separate entity principle. The different treatment under different national laws of financial instruments occurs irrespective of whether they are used by MNC affiliates or independent companies. However, MNCs may choose to structure their financial arrangements using hybrid instruments for tax avoidance purposes. If tax authorities remain shackled to the `separate entity' principle they will be obliged to apply the type of complex rules proposed here, to attempt to decide whether the choice of instrument is motivated by tax avoidance.

As we have argued in section 1, more effective solutions should be based on adopting a unitary approach. Such an approach would entail treating a firm's capital on a consolidated basis. This would be compatible with the preference of banking regulators, mentioned in

para.160 of the discussion draft, for treating regulatory capital on a consolidated basis, and either encouraging groups to issue such capital at top holding company level, and/or disregarding instruments issued at subsidiary level.

**2.3 Hybrid Entity Payments**

*1.1.Is it clear what elements need to be present in order for the rules neutralising deductible hybrid entity payments to apply?*

*1.2.Is the outcome of the rules' operation clear?*

*1.3.Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?*

*1.4.Are there any related party structures where the hybrid entity may have difficulty in knowing or obtaining information about the position of the investor?*

*1.5.If so when would these arise and what difficulties or constraints would the hybrid entity face?*

**2.4 Imported Mismatches and Reverse Hybrids**

*Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?*

*Is it clear what elements need to be present in order for the defensive rule neutralising reverse hybrids and imported mismatches to apply?*

*How could an anti – abuse provision be drafted so that it prevents otherwise unrelated parties from entering into arrangements to exploit mismatch arrangements?*

**Our comments**

In the example described in paragraph 208, why would the intermediary country – Country B in the example – care about implementing rules to neutralize the effect of HMAs where that country's tax revenue is unaffected. In other words, why would Country B – the intermediary jurisdiction in an 'imported HMA' – care about the effect that the HMA has in Countries A and C? We refer to our comments and question in section 2.1 above about how the coordination necessary for effective implementation of these proposals will be achieved.

**2.5 Further Technical Discussion and Examples**

*Do these technical recommendations assist in understanding and applying the rules?*

*Are there further technical recommendations that should be addressed in the final report?*

**Our comments:**

With respect to intra-group financial transactions involving sale of shares ('repos and sale-leasebacks') the Draft on HMA should contemplate in further detail the option of payment-recharacterization. In most situations the recommendation is to deny the interest or rent deduction, and second, to force the inclusion of the payments in the subsidiary's income. However, the OECD should analyse the extent to which changing laws to allow the recharacterization of repos and sale-leasebacks to treat them as loans could benefit countries;

these transactions are commonly used for financial purposes and should not be disguised as something other than the loans they represent.

The expression `acting in concert' should include any otherwise unrelated bank, financial institution, or other person that plays an intermediary role in any arrangement. The definition in the box on page 35 of `acting in concert' does not clearly include such intermediary persons. Their inclusion should be made crystal clear.

**Comments related to Tax Treaty Issues**

*Entity characterization*

Currently most countries characterize the foreign legal entities based on domestic corporate law rather than the characterization of the country of residence. This is the core enabler of HMAs. Therefore, consideration should be given to the tax treatment of these entities and whether they are liable to tax and effectively pay tax in their home jurisdictions. In this respect we welcome the recommendation to add paragraph 2 to the Article 1 of Model Tax Convention. Implementation of such a measure should be done through the proposed multilateral instrument, since relying on changes to bilateral treaties would lead to many years of delay.

*Non-Discrimination*

As indicated above, we are concerned that no specific proposals are put forward in respect of the application of the non-discrimination clause that obliges the countries of source to permit deductibility of payments, which may be payments made to HMAs. Similarly, implementation of such a measure should be done through a multilateral instrument.

The Voice of OECD Business

Paris: 2 May 2014

# OECD DISCUSSION DRAFT ON BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

*Submitted by email: aggressivetaxplanning@oecd.org.*

Mr. Achim Pross,
Head, International Co-operation and Tax Administration Division,
Centre for Tax Policy and Administration,
Organisation for Economic Cooperation and Development

Dear Achim,

Please find below BIAC's comments on the OECD Discussion Draft on BEPS Action Item 2, *Addressing Hybrid Mismatch Arrangements* issued on 19 March 2014 (the "Discussion Draft" or "paper").

The Base Erosion and Profit Shifting ("BEPS") project has a very ambitious timetable, so we thank Working Party 11 ("WP11") for reaching out to stakeholders in a number of ways, and for issuing an early, non-consensus document in order to gain stakeholder input as soon as possible. We also thank WP11 for a slightly longer comment period than has been normal for other BEPS consultation documents. In order to help the working party in its deliberations, BIAC is submitting a consensus document that represent business views generally, rather than simply passing on views from our members.

## General Comments

It is important to be very clear at the start that BIAC acknowledges that some hybrid transactions – involving both instruments and entities – can lead to exactly the base erosion, and in some cases, double non-taxation, that the G20 leaders identified as requiring action. Further, we understand that action will be taken in these areas and we have already been engaging constructively with WP11 and the Secretariat to help fashion proportionate and workable rules.

Our letter does highlight, however, at least four major concerns which we believe should be taken into account if this project is to be successful: the interaction of this Action Item with others (especially on CFCs and interest deductibility); the complexity of the potential rules; the impact on certain market segments (especially in the financial services sector (FS)); and the allocation of taxing rights issue embedded in the imported mismatch proposal.

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## Interaction with other Action Items

We believe that there has to be more acknowledgement and study of the interactions between this Action Item and others. This is important on a number of levels. First, to act on hybrids without acting on other BEPS techniques that do not require hybrid transactions, but achieve similar results, would result in an unequal playing field. At another level, hybrids are really a symptom rather than a cause of BEPS. That cause would be more comprehensively dealt with under, for example, consideration of Action item 4 and expense deduction.

## Complexity of the Rules

There seems to be a widespread misconception that hybrid results (especially in the related party context) are simple to ascertain and quantify. That is not the case. Often the treatment in another country is unclear (even in the related party context) as to accounting, partial coverage, etc. In the unrelated setting these problems multiply. We believe that the Discussion Draft should be more realistic about this complexity, and where appropriate indicate that further time may be necessary to reduce that complexity and meet the "Design Principles."

## Impact on certain Market Segments

Owing to the time constraints (and notwithstanding the Herculean efforts of the Secretariat, Focus Groups, and WP11 more generally) it has not proved possible to fully investigate the effects of these rules on very important segments of the economy. To give just one example, the effect on the FS Funds sector, and their methods for going to market, would be enormous but there has not been enough time to investigate these and meet the BEPS objectives while at the same time allowing an important (and beneficial) business to continue. And this is just an example. BIAC suggests that WP11 identify areas where action is needed now, while allowing further time for consideration of others areas.

## Allocation of Taxing Rights

This interacts to some extent with our second point, but the issue is: if the country receiving the hybrid payment (A), and the country from which the payment is made (B) respectively decide neither to include that payment, nor deny a deduction, should a third country (C) from which there is a non-hybrid payment to Country B, be automatically entitled to deny an otherwise allowable deduction? Without enquiry into the policy rationale of Country A and B, that does have the appearance of a "soak-up" tax. And to the point made earlier, again, if such a payment is objectionable there should be a more general consideration of whether it should be dealt with under Action Item 4 so that there is equal treatment of both hybrid and non-hybrid payments. We believe that this involves a troubling extension of the general hybrid rules; and that further study is required to determine whether any such extension of the rules is warranted.

**********

We hope that WP11 finds our comments useful. Again, and to reiterate, we do understand the G20 mandate on this, and are committed to helping achieve that – but in a balanced and proportionate way that does not create winners and losers, and addresses not just symptoms but causes. We hope that WP11 will not hesitate to continue to call upon us for any help that we might be able to give.

Sincerely,

Will Morris
Chair, BIAC Tax Committee

cc: Mr. Pascal Saint-Amans,
Director of the Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development

# BIAC consensus responses to OECD Discussion Draft

## General Comments

1. BIAC welcomes the opportunity to comment on the Discussion Draft and we commend the work of the OECD Hybrids Focus Group and the OECD Secretariat for producing such a detailed set of technical proposals in an extraordinarily short time frame.

2. We fully appreciate the OECD's concerns about tax mismatches between countries, and the political imperative behind the BEPS process to develop proposals that will mitigate those concerns. However, there are potentially significant risks associated with the proposals as they stand. We stand ready to work constructively with the OECD to address those risks and to develop practical and targeted solutions to BEPS concerns.

3. The reach of the OECD's proposed rules would be very broad, impacting all sectors and a significant amount of existing investments and transactions. Close coordination with other BEPS Actions (including the work streams on controlled foreign corporations (CFCs), interest deductibility, and harmful tax practices) is imperative to ensure a proportionate and balanced outcome that does not create unintended consequences or an un-level playing field for businesses or governments.

4. Throughout this response, we focus on the following two thematic factors that make combating base erosion through limitations on hybrid arrangements particularly challenging:

   i) Hybrid arrangements are only one of the factors that create cross-border tax mismatches. We believe that full consideration of other factors that drive mismatches is critical to reach a proportionate and effective solution across this and the other BEPS actions.

   ii) Aligning the tax impact of cross-border hybrid mismatches involves inherent complexity, with associated administrative and compliance challenges. We believe that the challenges created by complexity are being underestimated. Although action is needed to address BEPS concerns, that action should not come at the price of undue complexity and associated uncertainty and unintended consequences. Once again, we are committed to contributing to the development of sustainable and practical solutions.

### *Cross-border mismatches*

5. Countries undertake tax policies based upon many fiscal, economic and political considerations. Because of differences in the tax rules of each country, cross-border tax mismatches arise. Hybrid arrangements are only one of the factors that create such tax mismatches. Other factors include differences in statutory tax rates, investment incentives, and specially-targeted deductions. The breadth of factors creating cross-border tax mismatches is not surprising given the wide variations in tax systems of different countries.

6. The Discussion Draft does not articulate an overarching policy reason for distinguishing between the tax effects of hybrid arrangements and the effects of other types of mismatches arising from the tax policies of different countries. Both the tax provisions resulting in hybrid mismatches and the tax provisions resulting in other types of mismatches are generally the

result of well-considered fiscal, economic and political decisions in each country. BIAC requests that the OECD articulate the policy rationale for distinguishing between hybrid arrangements and other types of mismatches, as this would help inform decisions about the adoption of the proposed rules and the appropriate scope and contours of those rules.

7. Because other tax provisions can produce results that are economically similar to the impact of hybrid arrangements, it is important that the proposed hybrid rules be coordinated with other BEPS actions (including the work streams on CFC rules, interest deductibility and harmful tax practices). These other work streams can provide effective protections against BEPS from both hybrid arrangements and other sources of tax mismatches. In this respect, the proposed hybrid rules can operate more narrowly to fill gaps in these other provisions.

### *Complexity of administration and compliance*

8. Two of the key "design principles" identified in the Discussion Draft are:

   i) to be workable for taxpayers and to keep compliance costs to a minimum; and

   ii) to be easy for tax authorities to administer.

9. We do not believe that the proposed rules satisfy these important benchmarks.

10. Any rules directed at limiting cross-border hybrid mismatches are inherently complex, because determining the applicability of the rules requires an understanding of the tax treatment in two countries (or, under the proposed rules, in some cases, multiple countries). The tax treatment in a country, and consequently the results under the proposed hybrid rules, may be complicated and uncertain. For example, determining whether a financial instrument is treated as debt or equity under a country's tax laws is often not straightforward.

11. The Discussion Draft proposes an extremely broad and complex set of interrelated rules to align the tax results of hybrid transactions. Different rules would apply to different categories of transactions. Each category is governed by primary and secondary "linking" rules, which provide for the denial of deductions or inclusion of income. However, the primary and secondary rules differ among the categories of transactions. Moreover, where a country has a dividend exemption system, a separate set of rules apply to hybrid instruments in lieu of the otherwise applicable primary and secondary rules.

12. The extent to which the rules apply to unrelated and related-party transactions differs depending upon the category of transaction – further increasing complexity. Moreover, the Discussion Draft suggests that the application of the rules to investors and issuers may differ in unrelated-party transactions.

13. The proposed rules cover an extremely wide range or transactions. For example, the definition of Hybrid Instrument broadly includes any transaction where a payment made under the arrangement is deductible in the payer's jurisdiction but not included by the recipient as ordinary income. Given the variations in tax systems in different countries, such asymmetries are likely to be widespread.

14. The proposed rules apply automatically regardless of the parties' intention in entering into the transaction, and without a qualitative assessment of whether the transaction achieves a tax result inconsistent with the policies of the countries involved.

15. Moreover, under the proposed rules, in the case of one type of transaction, Imported Mismatches, a country would deny deductions with respect to a non-hybrid transaction because other countries do not apply the proposed rules to an associated hybrid transaction. This gives rise to particular complexity and difficult issues regarding the allocation of taxing rights across jurisdictions (as described below).

16. An important theme in the Discussion Draft is that the coordinated, multilateral adoption of consistent hybrid limitations will largely mitigate the complexity of the proposed rules. However, under the proposed rules, individual countries are given discretion to define the scope of the rules in important respects. For example, countries are given discretion to define the scope of transactions covered by the Hybrid Instrument rules. It is likely that individual countries will adopt different variations or interpretations of the rules, creating complexity.

17. The Discussion Draft proposes information reporting requirements to mitigate the administrative//compliance burden of the proposed rules. However, such information reporting itself could create substantial complexity and an administrative/compliance burden.

18. One aspect of the proposed rules that is important is the need to be compliant with EU law on the free movement of capital. Otherwise, different standards will likely apply to different regions. This would substantially undercut the OECD's objective of global adoption of consistent hybrid limitations, creating complexity and distortions in the application of the rules. We believe this may require further study.

19. In sum, the burden on tax officials in administering these proposed rules and on taxpayers in complying with the rules should not be underestimated. This is certainly the case with transactions between unrelated parties. However, even in the case of transactions between related parties, the administrative/compliance burden is likely to be substantial. Companies often operate through global supply chains to achieve production and other economic efficiencies. These global supply chains are linked through intercompany transactions. Moreover, as described further below, companies increasingly are raising third-party funding through centralised platforms both for regulatory reasons and to achieve economic efficiencies. In such cases, the proceeds from the third-party funding are routed to operating affiliates through intercompany transactions.

20. In these cross-border intercompany transactions, tax mismatches may arise simply as a result of inevitable asymmetries in the tax systems of different countries. The breadth of the proposed rules increases the likelihood of this arising. Global companies will need to establish significant compliance processes to ensure that they are not engaging in prohibited mismatch transactions.

### *Double Taxation*

21. The proposed rules, which are designed to eliminate cases of double non-taxation, might produce double taxation. Double taxation could result in a number of ways:

    i) incomplete coordination of overlapping hybrid limitations in different countries;

    ii) incomplete alignment of the rules with other domestic law and treaty provisions; or

iii) failure to take account of tax resulting from the distribution of earnings from one jurisdiction to another.

22. One important way in which double taxation can arise is the failure to take account of taxation by an investor country under CFC rules. The BEPS Action Plan states, as part of Action 2, that to the determination of whether an amount is included in income shall take account of whether the income is taxable under CFC (or similar) rules in the investor jurisdiction. The proposed rules, however, take this into account only with respect to certain categories of transactions (i.e., Reverse Hybrids), not with respect to others (e.g., Hybrid Instruments). The Discussion Draft states that taxation under CFC rules is not taken into account more fully because of concerns about the complexity and workability of such an approach.

23. Because of the risk of double taxation, BIAC recommends that taxation under CFC rules be taken into account in all categories of transactions, consistent with the BEPS Action Plan. CFC rules provide another important protection against BEPS, and this should be reflected in the hybrid rules. To the extent that the CFC rules operate to tax income, there is no need for the hybrid rules to apply.

24. In addition, hybrid entities are often used to mitigate double taxation through the reduction of foreign taxes. By neutralising the treatment of hybrid transactions, the proposed rules take away this tool for avoiding double taxation.

25. Because of the potential for double taxation as a result of the proposed hybrid rules, BIAC recommends that the enactment of the rules be clearly linked to the adoption of strong and expeditious dispute-resolution processes, including Mutual Agreement Procedures (MAP) and binding arbitration for cross-border disputes.

### *Interaction with Withholding Taxes*

26. It is common for countries to impose withholding tax on cross-border payments. The gross-basis withholding tax serves as substitute for the net-basis tax that would be imposed on a tax resident.

27. Withholding tax is commonly eliminated or reduced under bilateral tax treaties, to avoid the risk of double taxation. Increasingly, treaties (or countries individually) have applied rules for the treatment of payments to hybrid entities, to ensure that reduced withholding tax and other treaty benefits are claimed only by qualified residents subject to tax in a treaty jurisdiction. Indeed, Article 1(2) of the Discussion Draft on Hybrid Mismatch Arrangements (Treaty Issues) contains model language for the treatment, under treaties, of payments to hybrid entities.

28. The Discussion Draft does not address whether the proposed hybrid rules apply in cases where withholding tax is imposed on cross-border payments. If the proposed rules are applicable, how do they apply? Is there a denial of a deduction plus the imposition of withholding tax; or a denial of deduction together with an elimination of withholding tax?

29. BIAC recommends that the hybrid rules not apply if a payment is subject to withholding tax. If the purpose of the BEPS project is to eliminate untaxed “stateless” income, this condition is not present where withholding tax has been levied. This approach builds on the established precedent of addressing hybrid asymmetries through withholding tax and treaties, and avoids the additional complexity of overlaying a new set of rules.

### *Other limitations on base erosion and profit shifting*

30. As noted above, given that hybrid transactions are only one cause of cross-border tax mismatches, it is important that the proposed hybrid rules be coordinated with other BEPS Actions, including the work streams on CFC rules, interest deductibility and harmful tax practices. Action on hybrids should be taken only when the impact of the proposals under those other BEPS Actions can be fully considered and taken into account.

31. Given the complexity of hybrid rules and the fact that hybrid transactions are only one cause of cross-border tax mismatches, an important focus of the BEPS work streams should be on other provisions that apply to both hybrid and non-hybrid transactions. This would produce a comprehensive approach to tackling the causes of many BEPS concerns.

32. For example, on the payor side, the ability to claim a deduction is a product of the resident-country's policy regarding the amount of deductions allowable against the tax base. The impact of a deduction on the tax base does not depend on whether the deductible payment is part of a hybrid transaction. The deduction is the same regardless of whether it results from a hybrid or non-hybrid transaction.

33. In this respect, if there is a BEPS issue, a root-cause is the country's policy regarding the allowable level of deductions. The hybrid deduction is a product of this broader policy.

34. Payor-countries can, thus, protect their tax bases from excess deductions by adopting strong and internationally-consistent thin capitalisation rules, which would apply equally to deductions of all types. Countries may, indeed, favour this approach because it preserves tax neutrality across businesses operating within the jurisdiction (i.e., businesses are subject to the same limitations on deductions).

35. Similarly, on the investor side, the ability to earn non-taxable income is a product of the resident-country's policy regarding untaxed or low-taxed foreign earnings. Untaxed or low-taxed foreign earnings can arise from multiple factors – hybrid and non-hybrid.

36. Here again, if there is a BEPS issue, a root-cause is the country's policy regarding untaxed foreign earnings. The hybrid non-inclusion is a product of this broader policy.

37. In this respect, investor countries can broadly address base erosion concerns from multiple types of tax-mismatches through strong and internationally-coordinated CFC rules.

38. Because of the broad scope of these other provisions, BIAC recommends that these rules be looked to as a first line of attack in addressing BEPS concerns, with more narrowly-targeted hybrid limitations applied to fill in gaps in such rules.

### *Importance of Coordinated Action*

39. The Discussion Draft emphasises the importance of coordinated, multilateral adoption of consistent hybrid rules. BIAC concurs that any action taken to limit hybrid mismatches needs to be multilateral, coordinated and consistent across jurisdictions to limit complexity, double taxation and other tax distortions.

40. To this end, BIAC recommends that a process be established to ensure that any action by countries to adopt hybrid rules be closely coordinated. For example, a process could be established whereby implementation of hybrid limitations by any country would be deferred until a critical mass of countries has adopted similar limitations.

41. In addition, because of the linkage between the proposed hybrid rules and other methods of protecting against BEPS, BIAC recommends that no action be taken to enact Action 2 recommendations until proposals under other key BEPS Actions have been developed (including, in particular, the work streams on CFC rules, interest deductibility and harmful tax practices).

42. Such coordination would help to ensure that any action on hybrid transactions results in a balanced allocation of taxing rights across jurisdictions.

### *Scope of Rules*

43. Given the complexity of the proposed hybrid rules, and the potential for double taxation and other unintended consequences, BIAC recommends that the scope of the proposed rules be more narrowly targeted. Although some countries have adopted various forms of hybrid limitations, the scope of the proposed rules is unprecedented. BIAC believes that it would be prudent to implement, at least initially, a narrower set of rules. This would provide time to evaluate the impact of these rules. If, over time, it becomes evident that additional rules are needed, they then can be adopted.

44. In response to concerns about complexity and over-breadth, the rebuttal has been made that: taxpayers can avoid these problems simply by not engaging in hybrid transactions. This presumes, however, that all hybrid transactions are the result of affirmative tax planning, which is not the case. Moreover, taxpayers will face a significant compliance burden in establishing that they do not have prohibited hybrid arrangements. This compliance burden is magnified if taxpayers are required to obtain information from parties that are not within their control.

45. The Design Principles set forth by the OECD include the objective that the rules be balanced to minimise compliance and administration costs, avoid double taxation and otherwise limit unintended collateral consequences. The Design Principles, by their terms, therefore require that consideration be given to these factors, rather than simply answering any query relating to complexity, double-taxation or other adverse consequences with an admonition not to enter into hybrid transactions. Genuine effort must be made to reduce the complexity, compliance burden, double taxation and other adverse consequences to the minimum consistent with addressing the BEPS issues. We do not believe that the proposed rules satisfy these important Design Principles, as the rules are currently drafted.

46. BIAC, thus, makes the following recommendations for narrowing the scope of the proposed rules, as discussed further below:

    i) For purposes of the proposal, a hybrid instrument should be limited to an instrument that represents an investment in debt or equity of a related party, except in the case of a tax-motivated “structured transaction” (as described in the Discussion Draft);

ii) A hybrid transfer should be limited to a transfer of an instrument that represents a debt or equity investment in an entity that is related to one of the parties to the transaction (except in the case of a tax-structured transaction);

iii) The proposal should narrow and define in more detail what is meant by includable in "ordinary income;"

iv) The proposal should not apply to transactions between unrelated parties, except in the case of tax-structured transactions;

v) The affiliation threshold for the definition of a related party should be increased to a level of 25% or higher (in the absence of a more detailed definition that depends upon the facts);

vi) The proposal should not apply to hybrid regulatory capital, including intra-group hybrid regulatory capital; and

vii) The Imported Mismatch rule should be dropped from the proposal.

47. As noted above, if after adoption of these narrower rules it becomes evident that additional limitations are necessary, they can then be adopted.

## Hybrid Instruments

### *Definition of Hybrid Instrument*

48. The scope of "instruments" covered by the proposed Hybrid Instrument rules is very broad. The Discussion Draft states that "*a hybrid financial instrument should be defined broadly so as to capture any financial instrument (including a hybrid transfer) where a payment made under the arrangement is deductible in the payer's jurisdiction but not included by the recipient as ordinary income when the recipient calculates its net income for tax purposes*." (p.25)

49. The Discussion Draft states that, for this purpose, "ordinary income" means "*income that is subject to tax at the taxpayer's full marginal rate and that does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular categories of payments."* (p.28) This casts a very wide net and may have untended consequences. Here again, if the purpose of the BEPS project is to eliminate untaxed "stateless" income, this definition goes well beyond that. For example, the proposal would appear to apply where the recipient jurisdiction characterises an item as capital gain, instead of ordinary income, subjecting the income to tax, though at a different rate than that applicable to ordinary income.

50. The proposed rules apply not only where the mismatch results from a general difference in the way an instrument is characterised for tax purposes, but also where there is a difference in the tax treatment of a particular payment made under the instrument (e.g. deferred subscription arrangements and convertible notes).

51. Cross-border mismatches in the taxation of financial instruments can be common, given the variations in the tax systems of different countries. The mismatches are often not the result of structured transactions designed to achieve a tax arbitrage. Rather, they simply result from differences in each country's tax rules.

52. The Discussion Draft states that that the types of financial instruments covered by the rules should be determined by the domestic law of individual countries (but that the rules should at least include anything that is treated as debt or equity under the laws of the jurisdiction applying the rule). We expect that this will lead to large country-to-country variations in the scope of the rules, which will increase their complexity. The Discussion Draft emphasises that consistent rules across jurisdictions are important for avoiding complexity and minimising the administrative/compliance burdens under the rules.

53. The proposed rules do not apply to timing differences in deductions and inclusions. However, the proposed rules will still require multi-year enquiries of future results where the deduction and inclusion occur in different periods, and may require potential future adjustments/reversals (e.g., as a result of a change of facts or law/accounting.), creating further complexity.

54. *Example:* Assume Company A, a resident of Country A, enters into a financial transaction with Company B, a resident of Country B. Under the laws of Country A, Company A accrues a deduction in Year 1 based upon the assumption that Company B will accrue an inclusion in ordinary income in future years, under the laws of Country B. There is a subsequent change of facts or law; and, as a result of this change, in future years Company B does not have an offsetting inclusion in ordinary income. Will this require a reversal of Company A's Year 1 deduction?

55. The proposed definition of a hybrid instrument is overly broad and unclear. BIAC makes the following two recommendations to clarify and narrow the scope of the proposal:

    i) The proposal should narrow and define in more detail what is meant by includable in "ordinary income."

    ii) The proposal should be limited to financial instruments that represent an investment in debt or equity of a related party. These types of instruments appear to be the principal focus of BEPS Action 2.

56. Narrowing the scope of the proposal in this way should limit compliance costs, reduce uncertainty in the scope of the rules and avoid unintended consequences.

57. The rules could be applied more broadly in the event of a transaction representing a tax-motivated "structured arrangement" (as described in the Discussion Draft).

### *Application to Unrelated-Party Transactions*

58. The Discussion Draft identifies two alternative approaches for defining the scope of the hybrid instrument rules: a "bottom-up" approach and a "top-down" approach. Under the bottom-up approach, the rules would apply to (i) instruments held between related parties, and (ii) instruments entered into as part of a tax-motivated "structured arrangement." Under the top-down approach, the rules would apply to all transactions involving hybrid instruments, with certain limited exceptions (e.g., instruments widely-held by unrelated parties).

59. As described above, BIAC recommends that the definition of hybrid instrument be limited to investments in debt or equity of a related party, except in the case of tax-structured transactions. This would, by definition, limit the rules to related-party transactions.

60. Even if the definition of hybrid instrument is not limited in this way, BIAC believes that the rules should apply a bottom-up approach and exclude all transactions between unrelated parties, except for tax-structured transactions. Apart from tax-structured transactions, the risk of base erosion in unrelated-party transactions would not appear to be high.

61. On the other hand, the complexity and administrative/compliance burden of applying the rules to unrelated party transactions would be substantial. The Discussion Draft outlines the complexity and challenges likely to arise, including the information-reporting required to inform the issuer of the tax profiles of unrelated holders, or to inform the holders of the issuer's tax position; and the need to regularly update this information. The complexity and administrative/compliance burden would appear to substantially outweigh any risk of base erosion.

62. Apart from the administrative challenges, applying the matching requirement to unrelated-party transactions could have an adverse impact on global capital markets. Decision-making in global capital markets could be distorted, as investors may shy away from securities issued by foreign companies due to tax uncertainty. Issuers would have more limited sources of capital, driving up the cost of capital.

63. The Discussion Draft raises the question of whether investors should be subject to the proposed rules in transactions between unrelated parties, even if issuers are not subject to the rules. The Discussion Draft notes that, under such an approach, information reporting might nevertheless be required of issuers. Because of such complexities, we recommend that investors, as well as issuers, be excluded from the rules, except in the case of tax-structured transactions.

64. Trying to carve out unrelated-party transactions under a top-down approach would be inordinately difficult. It would be extremely hard to anticipate all of the transactions that should be excluded from the rules.

65. It is important that any carve-out for unrelated-party transactions not disadvantage groups that issue third-party securities from centralised funding platforms and subsequently route the resulting funds to operating affiliates through intercompany transactions, instead of issuing debt directly to the market from operating affiliates. The OECD acknowledges this point with respect to hybrid regulatory capital. In particular, the Discussion Draft notes that, as part of a move toward a "single-point-of-entry" approach to financial resolution, regulators are increasingly encouraging banking groups to issue loss-absorbing capital at the top holding company and pass this capital down through the group via intercompany transactions. The OECD has requested comments (discussed below) on how to address related-party hybrid capital in this context.

66. Companies, however, issue third-party securities through centralised funding platforms for non-regulatory reasons as well, to achieve non-tax funding efficiencies. Issuing securities through a centralised platform avoids market confusion that can arise as a result of issuances from multiple affiliates. It also can limit risk to investors by issuing securities that are recourse against the consolidated assets base of the group. It is important that the hybrid rules do not create a tax distortion that alters the decisions companies would otherwise make to fund through a centralised platform to achieve non-tax efficiencies.

### *Definition of Related Party*

67. The Discussion Draft suggests that the affiliation threshold for determining whether a person or entity is a related party should be set at a very low level (e.g., 10% or greater), for the purpose of any carve-out for unrelated-party transactions. Such a low threshold would create substantial compliance difficulties. On the other hand, the likelihood of base erosion at such affiliation levels would not appear to be high, apart from tax-structured transactions.

68. The difficulties in obtaining the information necessary to comply with the proposed rules are magnified in the case of collective investment vehicles and joint ventures.

69. In concept, the definition of related party should be based upon control – that is, whether the level of affiliation provides sufficient control to allow information to be obtained to comply with the provisions, without undue cost or difficulty. The requisite control may differ depending upon the circumstances.

70. In the absence of a more detailed definition that depends upon the facts (e.g., joint venture, investment fund), BIAC recommends that the affiliation threshold be set at a level of at least 25%. This question would benefit from further study, which may reveal that a higher threshold is required (e.g., "greater than 50%").

## Hybrid Transfers

71. One of the examples of a hybrid transfer in the Discussion Draft involves a purchase-resale of shares that, in economic substance, is equivalent to a secured loan. This "Repo" transaction produces a cross-border tax mismatch. The transaction is treated in one jurisdiction in accordance with its form – a purchase and resale of shares – and is treated in the other jurisdiction in accordance with its substance – a secured loan.

72. Another example in the Discussion Draft involves a lending of shares. This "Securities Lending" transaction also produces a cross-border tax mismatch, as each party is treated as the owner of the shares in its country of residence.

73. These highly tax-structured examples in the Discussion Draft are understandably within the scope of the proposed hybrid rules. However, there is a multi-trillion dollar market in ordinary-course Repo and Securities Lending transactions. Repos and Securities Lending provide an important source of liquidity to the financial markets.

74. These ordinary-course Repo and Securities Lending transactions are often between parties in different jurisdictions. The transactions, as a result, might be treated differently for tax purposes in the respective jurisdictions. These ordinary-course transactions, however, are not undertaken to achieve a tax arbitrage.

75. Importantly, these ordinary-course transactions are not undertaken solely between unrelated parties. It is not uncommon for these transactions to be undertaken between affiliates within a financial institution. For example, bank affiliates may focus on separate geographical markets and the affiliates may enter into transactions in the ordinary course to intermediate these markets. Alternatively, a bank group may consolidate the separate trading positions of affiliates on a regular basis through intercompany transactions.

76. If these proposed hybrid rules were applied to ordinary course Repo and Securities Lending transactions, the compliance burden and potential tax complications and uncertainties could disrupt the market. These are low-margin high-volume transactions, so there likely would be a relatively low threshold for disruption.

77. In light of these considerations, BIAC recommends that the definition of hybrid transfer for purposes of the proposed rules be limited, consistent with the definition of hybrid instrument. Specifically, the proposed rules generally would apply only to a transfer of an instrument that represents a debt or equity investment in an entity that is related to one of the parties to the transaction. This should have the effect of carving out ordinary-course Repo and Securities Lending transactions.

78. As in the case of hybrid instruments, the proposed rules could be applied more broadly in the case of a tax-motivated structured transaction.

## Tax-Structured Arrangements

79. Under the Discussion Draft, transactions that generally do not fall within the proposed rules, would nevertheless be subject to the rules if the transaction is a tax-motivated "structured arrangement." BIAC supports this approach.

80. Identifying tax-motivated structured arrangements, at its core, involves an enquiry into the purpose of a transaction. Such an approach has both the virtue of providing flexibility in targeting appropriate transactions and the drawback of uncertainty and potentially, costly disputes.

81. To limit uncertainty, the Discussion Draft provides that the determination of whether a transaction is a tax-structured arrangement is to be tested by evaluating the transaction under a list of readily-identifiable, objective factors. BIAC supports this approach. To further limit uncertainty, it would be helpful to establish presumptions and safe-harbors.

82. The key to this approach is identifying factors that are reliable indicators of a tax-motivated structured arrangement.

83. For example, one of the factors identified in the Discussion Draft is whether the pricing of a transaction reflects the expected tax benefit from the hybrid mismatch. One would expect the pricing of a tax-structured arrangement between unrelated parties to reflect an allocation of tax benefits. However, in an ordinary-course transaction that is subject to competitive market pricing, the pricing will also tend to reflect, at least in part, the tax attributes of the parties. For example, if an ordinary-course issuance of shares is held by investors who qualify for a partial exemption from tax on gain in the value of the shares, this will tend to be reflected in the competitive market-pricing of the shares.

84. However, in a highly tax-structured arrangement between unrelated parties, it is common for pricing and other terms to be adjusted if the expected tax result is not achieved. In an ordinary-course transaction, the pricing and other terms are unlikely to be subject to such an adjustment.

85. One approach taken by countries in combating highly-structured tax-motivated transactions is the adoption of disclosure requirements. Requiring taxpayers to disclose such transactions

can itself be an effective deterrent. BIAC, therefore, recommends that this aspect of the work stream for Action 2 be coordinated with the Action 12 work stream.

86. Developing the details of the approach to defining tax-structured arrangements will require careful analysis – balancing flexibility against uncertainty. BIAC is mindful of the short scheduled time-frame for completing Action 2, and encourages the OECD to take the time necessary to develop a balanced and effective test.

## Hybrid Regulatory Capital

87. The Discussion Draft acknowledges that the treatment of hybrid regulatory capital of banks is an important issue that must be taken into consideration in developing rules for hybrid instruments. BIAC commends the OECD on this acknowledgement.

88. Hybrid regulatory capital is also important for other types of regulated financial institutions, including brokers, finance companies and insurers. Thus, the proposed hybrid rules will need to address the treatment of hybrid regulatory capital for all such regulated financial institutions.

### *General*

89. Following the financial crisis, the regulatory framework applicable to banks, brokers and finance companies has undergone substantial change. The types of entities subject to financial regulation has expanded, and the degree of regulation has increased, as regulators seek to protect creditors of such financial entities and to ensure that entities in financial distress can be satisfactorily resolved without resorting to taxpayer support. A key element of this regulatory framework is a requirement that such financial institutions hold minimum levels of capital. In particular, banks are required to hold 6% of their risk weighted assets in the form of “Tier 1” capital, of which 1.5% may be met with “Additional Tier 1” instruments.

90. Insurers are likewise subject to regulation to ensure that all liabilities to policy holders can be met. Regulators prescribe the amount and form of capital insurers are required to hold to cover potential liabilities and support future stability. As in the case with banks, brokers and finance companies, following the financial crisis there have been moves to harmonise the regulatory environment for insurers, but as of yet this has not been achieved outside of Europe. Therefore, for insurance companies, the capital requirements currently vary by jurisdiction; but they are becoming more unified in Europe and are becoming similar to the rules for banks.

91. Regulatory capital instruments of banks, insurers and other financial institutions are generally classified in Tiers: Tier 1 instruments are “less debt-like” than Tier 2 instruments, which are less debt-like than Tier 3 instruments, The main equity-like features of such instruments are:

    i) Permanence (perpetual or long maturity);

    ii) Loss absorption through subordination, principal loss, coupon cancellation;

    iii) No ability to trigger a regulatory or statutory insolvency; and

    iv) Preservation of resources during financial distress (e.g., through coupon deferral).

92. The recent regulatory developments outlined above have created a push for non-equity financial instruments to have capital attributes similar to equity. An important, evolving sub-tier of capital is "Additional Tier 1" capital ("AT1"). AT1 capital generally consists of subordinated debt, with certain equity-like features, such as mandatory conversion to ordinary shares in the event of financial stress.

93. The tax treatment of AT1 capital in jurisdictions around the world is evolving. Nevertheless, it is emerging that the tax treatment of the instruments will differ from jurisdiction to jurisdiction due to their debt and equity-like features. As such, AT1 instruments potentially fall within the scope of BEPS Action 2. It is important that the proposed hybrid rules do not apply to AT1 instruments, so that the BEPS project does not discourage financial institutions from issuing such forms of regulatory capital, which would be counter to regulatory objectives.

94. This point was acknowledged by HM Treasury in its recent document setting out priorities for the BEPS project, "Tackling aggressive tax planning in the global economy" (March 2014), which states that "thought will also need to be given to the treatment of hybrid regulatory capital held by the financial sector, where the hybrid nature of the instrument is essentially imposed by the regulator rather than being chosen by the business. The concern would be the extent to which anti-mismatch rules might disincentive regulated financial institutions from raising capital in more loss absorbing forms, an outcome which would be counter to regulatory objectives."

### *Hybrid Capital Issued to Unrelated Parties*

95. As discussed above, BIAC recommends that, under a "bottom-up" approach, hybrid instruments issued to unrelated parties be excluded from the scope of the hybrid rules, except for tax-motivated structured transactions. Even if all transactions between unrelated parties are not generally excluded from the scope of the rules, for the reasons described above BIAC recommends that a carve out be provided for hybrid regulatory capital.

### *Intra-Group Issuance of Hybrid Regulatory Capital*

96. Increasingly, regulators are encouraging banking groups to raise capital through a single funding entity (typically, a top-tier holding company) and moving capital into locally-regulated entities via intercompany funding. This facilitates a consolidated approach to resolution in the event of bankruptcy or a similar proceeding.

97. We commend the OECD for recognising this point in its Discussion Draft, where it states: "As part of a wider move towards a 'single point of entry' resolution, a number of regulators are encouraging banking groups domiciled in their jurisdiction to issue all their loss absorbing capital at the top holding company level and then pass this capital down through the group to the relevant operating subsidiaries….These arrangements may also be motivated by the fact that regulatory capital issued directly to the market at subsidiary level may, in certain circumstances, be discounted or disregarded for consolidated regulatory purposes."

98. Similarly, capital raised at the group level is most effective for the consolidated capital position of insurance groups, because it is most fungible.

99. Given the increasing importance of this "single-point of entry" funding model, it is critical that intra-group issuances of hybrid regulatory capital be excluded from the proposed hybrid rules,

along with third-party market issuances. Inconsistent treatment of intra-group regulatory capital and capital issued to the market would create tax distortions in a financial institution's consolidated regulatory capital. This would put companies operating under a single-point-of-entry funding model at a competitive disadvantage relative to companies issuing directly to the market at the subsidiary level. Financial institutions, in sum, would have a tax-disincentive to adopt a single-point-of-entry funding model. Taxes should not distort in this way the regulatory capital structures that financial institutions would otherwise adopt.

100. BIAC recognises that developing an appropriate approach to the treatment of intra-group regulatory capital requires careful consideration. The existence of AT1 capital instruments is relatively new and the adoption of single-point-of-entry funding models by financial institutions is evolving. This suggests adoption of a flexible approach to accommodate the evolving capital needs of financial institutions and requirements of regulators. BIAC is mindful of the short scheduled time-frame for completing work on BEPS Action 2, and encourages the OECD to take the time necessary to develop appropriate recommendations on this important issue.

## Imported Mismatches

101. Section VI of the Discussion Draft applies to two types of transactions: i) Reverse Hybrid transactions, and ii) Imported Mismatch transactions.

102. For Imported Mismatch transactions, the entity making a payment is not a direct party to a hybrid transaction. Rather, an associated transaction involves a hybrid instrument or entity.

103. The Discussion Draft indicates that the Imported Mismatch rule is intended as a back-stop, applying in a case where the countries involved in the associated hybrid transaction do not apply the proposed rules. The examples in the Discussion Draft appear to describe back-to-back conduit financing transactions. The Discussion Draft notes that the intermediate entity pays no tax on the transaction because it has offsetting income and expense.

104. The Imported Mismatch rule, however, appears to apply much more broadly than solely to such back-to-back financing transactions. This is likely to create substantial complexity in administration and compliance.

105. The back-to-back funding examples in the Discussion Draft do not reflect the general complexities of intergroup financing within a Multinational Company ("MNC"). An MNC's treasury operation is constantly managing the group's sources and uses of cash. The funding of business operations changes on an ongoing basis, as excess cash produced by certain parts of the group is used to fund the needs of other parts. Often, this is accomplished through cash pooling arrangements under which cash from affiliates with excess liquidity is swept on a regular basis into a common pool from which affiliates with funding needs make cash draws. The terms of such cash pool arrangements vary; however, it is common for the arrangements to be treated as deposits/loans between cash-pool entities. The sources and uses of cash may be in different currencies.

106. This type of complex intra-group funding is not limited to financial services companies. It is present in the case of non-financial services companies as well.

107. As a result of such intra-group cash management, the funding of a business often will come from different intercompany sources; and these sources will change over time. In this context, the Imported Mismatch rule would be complex to administer, give rise to uncertainties and potentially result in double taxation.

108. The multi-jurisdictional complexity of the proposed hybrid rules is compounded under the Imported Mismatch rule. In general, the proposed rules require a taxpayer and tax administrators in a country to understand fully the tax consequences in a second jurisdiction of a transaction that occurs between the home country and the second jurisdiction. The Imported Mismatch rule requires a taxpayer and tax administrators in a country to understand fully the tax treatment in two other countries of a transaction that occurs in those other countries. Compliance is all the more difficult if the tax treatment in the two other counties is uncertain. Moreover, compliance requires an ongoing understanding of the tax treatment in two other countries if a transaction has accruals over a period of years.

109. The Discussion Draft acknowledges the complexity of applying the matching requirement in Imported Mismatch transactions. The Discussion Draft recommends information reporting requirements to mitigate the complexity. Such information reporting, however, creates its own complexity.

110. In addition to the complexity and administrative/compliance burden of the proposed Imported Mismatch rules, the proposal raises difficult questions about the appropriate allocation of taxing rights among jurisdictions. Specifically, if two countries involved in a hybrid transaction make policy decisions not to impose taxation, we do not think it is appropriate for a third country to step into that space and impose a tax through a denial of a deduction? This is essentially a “soak-up” tax.

111. Because of these problems, BIAC recommends that the Imported Mismatch rule not be included, at least initially, in the proposed hybrid rules.

112. If, over time, it becomes evident that a backstop to the general hybrid rules is necessary, an Imported Mismatch rule could be adopted. However, even then, any such rule should not apply automatically. It should be an anti-abuse rule that narrowly targets circumvention of the general rules – in particular, cases where a country is funded indirectly by a hybrid transaction to avoid being subject to the country’s hybrid limitation.

## Transition Rules for Existing Transactions

113. Hybrid transactions are the product of asymmetries in the tax laws of different countries. As such, any change in the laws to limit hybrid mismatches should include appropriate transition rules for existing transactions.

114. Restructuring undertaken by taxpayers in response to the change of law should not be subject to challenge under GAAR provisions.

OECD
By email: taxtreaties@oecd.org
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2 May 2014

Dear Sir or Madam,

**Re: BEPS Action 2**

I am writing to you on behalf of the British Private Equity and Venture Capital Association (the "BVCA"), which represents the interests of members of the private equity and venture capital industry. The BVCA is the industry body and public body advocate for the private equity and venture capital industry in the UK. More than 500 firms make up the BVCA members, including over 250 private equity, mid-market, venture capital firms and angel investors, together with over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

This note has been prepared by and is being sent on behalf of the BVCA's Tax Committee, whose remit is to represent the interests of members of the industry in taxation matters. The BVCA welcomes the opportunity to submit formally its comments on the two Public Consultation documents entitled BEPS ACTION 2: Neutralize the Effects of Hybrid Mismatch Arrangements (Treaty Issues) and (Domestic laws) released by the OECD on 19 March 2014 (the "**Consultation Documents**") and how it might affect members of our industry. Our comments in respect of the Consultation Documents are set out below.

## 1. Introduction

The BVCA fully appreciates the concerns of the OECD that action is needed to effectively prevent the use of hybrid instruments and hybrid entities to obtain tax advantages as a result of double deductions and deduction with non-inclusion. The BVCA also supports a coordinated and comprehensive international approach to tackle these important issues.

Private equity funds (and venture capital funds, which are not referred to separately in this note for reasons of clarity but operate in a very similar manner) exist to aggregate and deploy capital in order to generate investment returns. Investors into private equity funds are typically pension funds, family offices, insurance companies, banks, other investment funds (which may be in corporate, trust, partnership or other form), sovereign wealth entities, not for profit organisations such as local authorities, educational endowment funds and charities and individuals (including officers and employees of the fund manager or vehicles aggregating the interests of such persons). Investment may be made directly into a particular private equity fund or via a "fund of funds".

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British and other European private equity funds typically raise funds from investors in a broad range of jurisdictions, which tends to increase fund size and increase economies of scale, and typically invest in companies in a broad range of jurisdictions, which tends to diversify risk and maximise investment opportunities. It is therefore critical to many private equity funds that they can operate cross-border without undue tax problems, for the benefit of investors.

Private equity operates very differently from the large multi-national organisations on which BEPS is largely focused, and it is vital that these differences are understood and accommodated in order that the industry is not inappropriately disadvantaged, which would in turn lead to a disruption in global investment flows, impacting countries that rely on inward investment and reducing economic growth across the globe.

## 2. Hybrid instruments in the context of private equity

As explained above private equity raises funds from a diverse group of investors and deploys the funds to invest across a wide variety of jurisdictions. Private equity funds may, where considered appropriate, use complex instruments such as hybrids in the context of acquisition structures in order to meet the needs of investors. These instruments play an important role in matching those seeking to invest capital with those requiring investment. The framework for using hybrid instruments is a function of the wide and varied investor base of private equity funds and the wide range of their investment jurisdictions. The acquisition structures are typically not designed to give rise to non-inclusion or a double deduction, but are designed to provide flexibility to remit cash to investors and deal with the different needs of a diverse investor base, ensuring that investors pay tax at the time when they receive a cash return.

Unlike an international corporate group, a private equity fund has a finite life (between five and ten years, often with the possibility of a two year extension). From the outset of an investment, the manager of the fund must be mindful of and plan for this constraint. The mechanism for investing must enable the fund to be able to return all proceeds to investors from underlying investments within this time-frame – there is no mechanism for returning funds after the private equity fund has run its course. It is this imperative which drives the choice and terms of the instruments used to make the investment which might be a mix of equity, plain vanilla debt and – potentially – loans which have some equity-like features (so-called 'hybrid' instruments).

A private equity fund cannot and does not structure its investments to be tax efficient for each investor. But if a particular group of investors face a specific and commercially problematic tax problem, the fund may factor this into its choice of investment instrument. For example, the US tax system taxes investors on an accruing yield basis which would result in investors potentially being taxed before receiving cash from the fund (sometimes referred to as the "phantom income" problem). To the extent there is a tax advantage in the use of a hybrid instrument in this context, it is generally a timing advantage: the use of a loan note which has equity features may mean that tax is due when cash is realised.

If investors were to suffer tax before receiving any cash return on their investment, at a time when future cash returns are uncertain, this would effectively reduce investment returns, increase investment risks for investors and reduce the attractiveness of private equity as an asset class for many investors. This would be likely to reduce the amount of private equity capital available for investment.

## 3. Example structure and timing differences

(a) Our general comments above can be illustrated by reference to the structure described at figure 12 at paragraph 207 of the consultation document headed "Imported Mismatch from Hybrid Financial Instrument". That kind of structure is, in very broad terms, relatively common in a private equity context, subject to our comments below about the tax impact of the structure. In a private equity context, the structure is designed to provide flexibility in relation to returning funds to stakeholders but also match cash to tax payments in the hands of investors.

Typically in a private equity context the acquisition of a European group would be effected using a holding company financed by the fund. The fund (typically a tax transparent partnership) would incorporate an intermediate holding company which would in turn incorporate a local acquisition vehicle. The local acquisition vehicle would be financed with a mixture of equity and loans by the intermediate entity which would also be financed by a mixture of ordinary equity and loans. Some or all of the loans provided to the intermediate entity may take the form of hybrid instruments, in the sense that the instruments might be considered to be loan instruments for local tax and accounting purposes but equity in the tax jurisdiction of some of the ultimate investors.

In the intermediate company's residence jurisdiction, the return on the instrument may be treated as interest, which may be deductible on an accruals basis depending on the domestic laws of the relevant territory. Typically domestic laws will provide for appropriate base erosion protection (eg. rules on thin capitalisation, transfer pricing and re-characterisation) designed to ensure that only appropriate levels of interest are deductible. The intermediate company will also be receiving taxable income and will be taxable on its profit from the transactions, and in many cases the amount of that taxable profit will need to be supported by an appropriate transfer pricing methodology and report.

The ultimate investors will pay tax on the return in their residence jurisdiction depending on their domestic tax rules and their own tax attributes.

Many jurisdictions will treat this type of instrument as debt in exactly the same manner as the intermediate holding company's residence jurisdiction and therefore the instruments will not be a "hybrid" in relation to those two jurisdictions. The UK would be an example where instruments of this kind are typically treated as a debt, and where taxable investors would be taxed on the return as interest.

However, in the residence jurisdiction of some investors the return on the instrument may be taxed instead as a distribution. For example, in the hands of US taxable investors the return may be taxable as a distribution, such that it is taxed as ordinary income on receipt. The effect of this US treatment is essentially to delay taxation until cash is received when the return is paid.

(b) It is accepted that such structures can lead to timing differences as investors may not be taxed until the investment returns are received.

Typically the maximum deferral is between two and four years depending on when the investment is realised. There is no possibility of a long term deferral as there is a requirement to remit cash to investors as soon as possible as the fund managers are measured on cash returns. In addition, private equity funds' agreements with their investors will normally provide for a maximum investment period fund life, typically five and ten years, with the possibility of a two year extension. This leads to a natural fund cycle where commitments are sought from investors, investments are made in the first five years and realised within five to ten years. Consequently the concept of a long term deferral is not a characteristic of private equity.

We believe that mere timing differences of the kind described above should not be affected by the proposals in the consultation document.

We note that the consultation document appears to confirm that mere timing differences are not intended to be caught. The document states at paragraph 88 that: "[t]he recommendation is not intended to impact on questions of timing in the recognition of payments. Thus, a hybrid mismatch does not arise simply because the issuer accrues original issue discount over the term of the bond while the holder only recognises the corresponding income as redemption premium once the bond is repaid." This same principle should apply to timing differences of the kind described above.

(c) Indeed, if hybrid instruments which produce a mere timing difference were to be caught by the proposals, there would need to a relieving mechanism when such timing differences are reversed, to avoid double taxation for investors (ie. to avoid tax on accruals and tax again on receipt) or penal asymmetry (ie. tax for investors with no deduction for the payer). Such a mechanism might be possible, but it would be hugely complex across a diverse investor base. In addition, changes in investors and changes in fund profit sharing ratios would make administering the arrangements very difficult in practice.

(d) For completeness, we note that there can be cases in a private equity context where hybrid instruments give rise to permanent rather than mere timing benefits, including tax rate benefits, although we believe that such cases are a distinct minority of cases and we believe that such benefits are often not intended at the outset of a transaction. We acknowledge of course that the points made above in this section, relating to mere timing differences, would not apply in such cases.

**4. Lack of information needed to determine hybrid tax effects**

The proposed rules on hybrid instruments would require that:

i) The jurisdiction of the payer should deny a deduction for any payment made using a hybrid financial instrument, to the extent that that the payee/investor does not include the receipt as ordinary income under the laws of any jurisdiction.

ii) Jurisdictions should require a payee/investor to include any payment under a hybrid financial instrument as ordinary income to the extent the payer is entitled to claim a deduction for such a payment or equivalent tax relief and the payer's jurisdiction does not apply a hybrid mismatch rule under (i) above.

iii) A dividend exemption should not be granted under domestic law to the extent that the amount is deductible so that in these situations no mismatch will arise.

Further complex rules are proposed in relation to "imported mismatches" – see in particular paragraph 228 of the consultation document regarding the proposed interaction of the tax treatments in Country A, Country B and Country C.

In the case of a widely held private equity fund, it would be extremely difficult in practice to apply these rules. It will be very difficult for payers to know whether particular investors are required to treat payments as taxable income under their domestic tax laws and on what basis. Private equity fund managers will not generally be in a position to determine the precise tax treatment of any particular flow of income in the hands of their investors. Some information may be available to private equity fund managers, but not the entirety as some investors will be "funds of funds" and therefore the available information about the investors will be restricted to this point. Even if the information is available to the private equity fund manager, it may not be able to provide this information to the payer as the details may be confidential.

Some funds will be "open ended" or listed and in these circumstances the difficulties indicated above will be exacerbated as clearly it will be almost impossible to obtain information in relation to a constantly changing investor base.

The implementation of "imported mismatch" rules would be even more challenging, because it would require transparency of information at three levels (ie. fund investors, intermediate holding company and acquisition company).

## 5. Economic impact of disallowance

We also note that any disallowance of deductions under proposed rules is likely to have a distortive economic effect in the context of a private equity fund. The denial of a deduction will depend on the tax treatment of particular investors. However, the economic cost of that disallowance will be spread across the entire investor base. It will be borne in proportion to the amounts invested by fund investors, and therefore the cost of the disallowance will be suffered partially by investors for whom there is no hybrid arrangement.

## 6. Hybrid Entities

It is unusual for European private equity funds to use a hybrid entity but such entities are sometimes used as a pooling vehicle or fund vehicle particularly in the US. These entities are usually not set up to benefit from mismatches, but are hybrid due to the diversity of investors in different jurisdictions and the diversity of jurisdictions these vehicles invest in. Such an arrangement is not based on aggressive tax planning, but merely the result of different rules in different jurisdictions. These pooled vehicles rarely result in 'double non-taxation'. Their goal is to make it possible for different investors to pool their investments without creating an additional layer of tax, i.e. tax neutrality.

For example, it is common for the common investment vehicle to be structured as a partnership, but if, for example, investing in the United States, the vehicle will elect corporate treatment for US domestic tax purposes. The effect of this hybrid is twofold. First, investors that are resident in jurisdictions that have an income tax convention with the United States can maintain the same

treaty benefits the investor would have obtained if the investor had made the investment directly due to the fiscal transparency rules commonly applied in most income tax conventions. Second, if the investment generates income subject to net income taxation, the choice to make the vehicle non-transparent for US domestic tax purposes means that the vehicle, rather than the investors, will be subject to US net income taxation and the accompanying filing and reporting burdens. This avoids having the numerous investors, often hundreds and sometimes thousand, being subjected to filing tax returns in the United States. But it does not reduce the tax burden.

Taking into account their diverse ownership and structure, these pooled investment vehicles may become innocent victims of anti-treaty shopping rules and anti-hybrid rules and therefore should be carved out from the BEPS work streams. For example, if a fund has 200 investors from 10 different countries and ten US investors use a hybrid vehicle for their investment in the fund, it could trigger application of rules based on the Action 2 recommendations. Even though the other investors might be taxed on their investment income from the CIV, or may be exempt under local law, the recommended imported mismatch rules could allow all of the jurisdictions involved in making deductible payments through the CIV to deny deductibility for the entirety of their respective payments. Potentially, the sum of these disallowed deductions could be many times greater than any income that is not included as a result of the hybrid.

In such circumstances, we believe that any hybrid mismatch rules should only apply on a look-through basis to each investor (rather than tarring all of the CIV's investors with the same brush) and, in any case, should not apply to unrelated parties.

**7. "Bottom up" vs. "Top down" approach**

The "top down" approach would effectively be based on the premise that every hybrid arrangement must be caught unless specifically excluded. We hope that our commentary above demonstrates that, in a private equity context, hybrid instruments do not typically produce a tax result which should be caught by the proposals. A regime based on including all hybrids and then providing carve-outs or exceptions is likely to be practically difficult to implement and increases the level of uncertainty to an unacceptable level. We strongly urge a more limited "bottom up" approach to the anti-hybrid rule which can be more targeted and is less likely to impact on commercial activity.

**8. Related parties**

(a) In addition, we would suggest that there should be a much clearer separation between anti-hybrid measures applicable to instruments held by related parties and all other circumstances. The proposals in section IV.5. of the consultation document would create a multitude of implementation, information and technical concerns in a private equity context. Our recommendation is to treat collective investment arrangements, such as private equity and other forms of pooled investment, as a separate category, to take account of their specific facts and circumstances and the wide variety of investors by type, origin and tax status.

(b) We can appreciate that entities that are consolidated for financial accounting purposes represent members of the same control group, and therefore as policy matter must be within the rules.

(c) However, the term "related party" (paragraph 128) includes companies, funds and other entities and arrangements that would generally be expected to take into account the position of their non-portfolio investors (i.e. 10% or greater) when entering into their arrangements with those investors. The 10% threshold is too low given the complexity and risks of double taxation inherent in these rules. Therefore we suggest that the rules should not apply to unrelated parties and the definition of related party should be based on an ownership test of at least 50%. In the absence of central control a taxpayer who makes a payment to a 10% investor would not be in a position to obtain information on the tax treatment in order to comply with the rules on imported mismatches or reverse hybrids.

(d) The related party test also includes relationships described as "acting in concert" - parties that have a material interest in engineering a particular tax outcome where there are coordination mechanisms in place that allow them to undertake collective action. This includes shareholders or voting agreements, joint ventures and private equity funds under the control of a common manager. The consultation makes the assumption that such arrangements raise relationship issues that are similar to those presented by related parties under common control and should therefore be treated in a similar manner. We dispute the contention that in a private equity context all fund investors, who will typically be acting at arm's length from each other and from the fund manager, should be treated effectively as if they are all members of the same control group as each other and any company owned by the fund. Investors in private equity funds will typically consist of numerous dispersed investors. The position is very similar to the investors in a "widely held" instrument discussed at paragraphs 147 to 157 of the consultation document and therefore private equity funds with a wide investor base should be treated in a similar manner.

(e) We assume that, in any event, the debt which is typically borrowed by private equity sponsored companies from banks and other third parties, including the senior debt which is typically borrowed from a syndicate of banks, will fall outside the proposed rules because it will not be owned by any person "related" to the borrower and the bank syndicate (or other similar lenders) will not be viewed as "acting in concert". It would be useful if that could be clarified.

## 9. Administration

The comments above point to some of the issues for the private equity sector in administering these arrangements. To the extent that hybrid instruments are caught, the most practical approach would be that any disallowance is at the level of investors as they will be in the best position with deal with the administration required. It is essential the rules are implemented consistently and that the associated costs are minimised such that it does not impact on the wider business community. If the consequence is that different countries implement the rules differently and there is no consistency this would represent a major setback for business.

## 10. Purpose test

Objective mechanical tests may offer apparent certainty, but do not take into account situations that are not abusive but just happen to fall within the definition. To ensure that global commerce operates without distortion resulting from income tax considerations, such unintended applications of mechanical tests – which would be costly and counter-productive – must be avoided.

We believe a structured purpose test is essential to reduce the likelihood of unintended consequences and limit the collateral damage that could arise if the implementation of these proposals affects innocent parties or gives rise to double taxation. A structured purpose test would provide a subjective test of a taxpayer's motive, that is, whether the intent of a particular hybrid entity or transaction test is tax avoidance. Such a test would require a consistent standard, such as 'principal intent' or 'substantial purpose,' which could be applied to all situations. In order to ensure consistency, a structured purpose test should also include certain presumptions based on specified hallmarks of potential abuse.

A purpose test seems particularly important in the context of transactions between unrelated parties, where the potential for abuse is generally much lower.

Even in a related-party context, a structured purpose test would be helpful in ensuring that routine intercompany transactions reflecting normal business practices are not penalised simply because a hybrid transfer or entity happens to be involved. Alternatively, rules implementing the Action 2 proposals could include a 'business purpose' exception for related-party transactions, where the taxpayer has the burden of proof to show that such transactions have no tax avoidance motive.

## 11. Implementation and transition

It is clear from the complexity of the issues contained both in the consultation documents and our comments above that the scale of the issues in Action 2 is challenging. The objective of seeking a coordinated response across multiple jurisdictions is, we believe, essential. Nevertheless, such a coordinated approach will be very difficult to achieve in practice because individual jurisdictions have developed their tax laws to reflect a policy decision, for example, to allow a tax deduction in order to attract inward investment, which is their prerogative to do.

The debate on Action 2 can be distinguished from the BEPS work-stream on issues such as permanent establishment and profit attribution. In that domain, where one entity has a permanent establishment in another jurisdiction, both jurisdictions want to exercise taxing rights and look to the OECD to give guidance on a fair and consistent approach. In relation to hybrids, however, the OECD seems to be encouraging jurisdictions to tax instruments in certain circumstances even though it has made a policy decision not to do so and failure to implement this approach in a fully uniform manner will mean that it will not work as anticipated.

Therefore we feel it is essential that sufficient time is dedicated to allow for modifications to the design of the recommendations. In addition to adequate time, appropriate transitional arrangements should be put in place in order to ensure smooth implementation of any new rules, to ensure that they are focused only on abusive outcomes and do not result in outcomes which give rise to double taxation.

## 12. Summary

To reiterate the comments made above:

i. We believe the action designed to neutralize the tax effects of hybrids is an appropriate policy response.

ii. Private equity does use hybrid instruments – i.e. instruments which are treated as debt in the payer jurisdiction and equity in the recipient jurisdiction - but they generally give rise only to short term timing differences. We do not believe that such timing differences should be caught by the proposed rules. Indeed, it appears that the consultation document is not seeking to catch timing differences, but the position needs to be clarified.

iii. If timing differences were to be caught, there would need to be further complicated provisions to avoid double taxation for investors or penal asymmetry.

iv. The proposals require the relevant payers and payees to have detailed knowledge of the other's tax treatment, and that is very difficult in the context of a private equity fund. It is extremely difficult for private equity fund managers to establish the precise nature and timing of investors' domestic tax treatment on a particular flow of income.

v. In the event that an instrument is caught by the hybrid rules, the primary response should be inclusion at the investor level. This is consistent with the principle underlying a private equity fund that the investors should take responsibility for tax on investment income and gains. In addition a disallowance at the level of the portfolio company would result in the disallowance being borne by all investors and not just those benefitting from the hybrid treatment.

vi. In relation to whether the definition of hybrid should be "top down" and effectively treat all hybrids as bad with certain carve outs or focused on specific circumstances (the "bottom up" approach), our clear preference is for a "bottom up" approach as it will be more focused and less likely to lead to inadvertent commercial issues harmful to investment and the overall economy.

vii. The rules should only apply to related parties and the related party definition should be based on 50% ownership. A test based on a lower level of ownership will mean that taxpayers are not in a position to obtain information on the recipient's tax treatment and comply.

viii. The suggestion that investors and private equity firms represent "concert parties" is inappropriate. The investors in a private equity fund are similar to other public shareholders, indeed in many cases they will be same investors who are also shareholders across the listed markets and should be treated in a similar manner.

ix. Many countries already have extensive rules in relation to interest deductibility and therefore further limitations based on the use of hybrids seems "overkill" and will be harmful to economic activity. It is also important that any limitations are coordinated and consistent with BEPS Actions 3 & 4 on interest deductibility.

x. These rules will ultimately impose additional costs on business, for the payer and ultimate recipient, if only to ensure compliance with their obligations. Therefore it is incumbent on governments to ensure action is focused and costs are minimised otherwise this will impact the wider economy.

xi. The rules should include a purpose test to ensure the proposals do not inadvertently catch innocent transactions, reduce the compliance burden and ensure the rules do not impede international trade.

xii. The rules for hybrid entities should be clear and apply on a look through basis to each investor and in all cases should not apply to unrelated parties.

xiii. Given the complexity of the issues sufficient time should be provided to ensure that there is consensus and the rules can be enacted in a consistent manner. This should include appropriate transitional arrangements.

Thank you in anticipation for taking our comments into account as part of the consultation process. We would welcome an opportunity to engage more fully with the OECD in due course on this matter and would be pleased to discuss any of the comments made.

Yours faithfully,

Dominic Spiri

On behalf of the BVCA Taxation Committee

By email: Aggressivetaxplanning@OECD.org

2 May 2014

Dear Sir/Madam

**BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Recommendations for Domestic Laws)**

The British Property Federation (BPF) is the voice of property in the UK, representing businesses owning, managing and investing in property. This includes a broad range of businesses comprising commercial property developers and owners, financial institutions, corporate and local private landlords and those professions that support the industry.

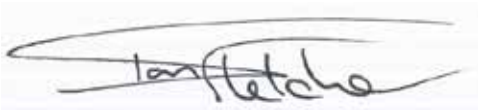
We are fully supportive of the OECD's efforts to ensure that hybrid mismatch arrangements are not used for tax avoidance purposes. The current effort to neutralise the effects of hybrid mismatch arrangements should recognise that for the most part, hybrid arrangements in collective real estate investment structures are used to ensure tax transparency, not to facilitate tax avoidance by creating mismatches.

We refer you to our response to the OECD's consultation on BEPS action 6 (preventing the granting of treaty benefits in inappropriate circumstances) which outlines the significance of real estate to the wider economy and the role of real estate investment structures in more detail.

The ability for real estate investment structures to repatriate profits to investors with limited tax leakage through intermediary entities is crucial to the economic viability of real estate investment. Therefore, we are keen to ensure that any changes to the taxation of hybrid arrangements do not affect the tax transparency of real estate investment funds, as that could inadvertently stem the flows of capital into real estate.

We would welcome the opportunity to discuss the contents of this letter in more detail. We remain at your disposal should you have any questions or require further details.

Yours faithfully



**Ion Fletcher**
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By email: Taxtreaties@OECD.org

2 May 2014

Dear Sir/Madam

**BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Treaty Issues)**

The British Property Federation (BPF) is the voice of property in the UK, representing businesses owning, managing and investing in property. This includes a broad range of businesses comprising commercial property developers and owners, financial institutions, corporate and local private landlords and those professions that support the industry.

We are fully supportive of the OECD's efforts to ensure that hybrid mismatch arrangements are not used for tax avoidance purposes. Hybrid entities and instruments are often used in real estate investment structures in order to ensure that investment structures are tax transparent. They are not generally used to facilitate tax avoidance as identified in the BEPS Action 2 paper and we would not support their use for such purposes.

We refer you to our response to the OECD's consultation on BEPS action 6 (preventing the granting of treaty benefits in inappropriate circumstances) which outlines the significance of real estate to the wider economy and the role of real estate investment structures in more detail.

Finally, given the importance of transparent structures and entities in real estate investment, we welcome the OECD's proposals to clarify the entitlement of treaty benefits for transparent and partially transparent entities. Further, we consider that it is appropriate for transparent entities to be treated in accordance with the principles of the Partnership Report.

We remain at your disposal should you have any questions or require further details.

Yours faithfully

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2. Mai 2014

**Public Discussion Draft**

Dear Madam/Sir,

Please find enclosed our comments regarding the BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws).

The Federal Chamber of Tax Advisers represents the interests of more than 91.000 tax advisers in Germany vis-à-vis the Bundestag, the Bundesrat, the federal ministries, the top echelons of the civil service, the courts and the institutions of the EU and OECD.

The main duties of the Federal Chamber of Tax Advisers are to represent the entire profession at national and international level, to participate in the drafting of the laws of the profession and in consultations on tax laws and laws in all other legislative areas of the profession.

Yours sincerely

Jörg Schwenker
Geschäftsführer

Encl.

Bundessteuerberaterkammer
KÖRPERSCHAFT DES ÖFFENTLICHEN RECHTS

**Enclosure**

# BEPS Action 2:

# Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)

**Abt. Steuerrecht**

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2. Mai 2014

## I. General Remarks

Bundessteuerberaterkammer supports every measure to prevent tax evasion.

The real cause of hybrid mismatch arrangements and deduction/non-inclusion schemes seems to us the divergent domestic tax law of countries.

Burdens have to be shared between different countries.

In order to prohibit distortions of competition, implementing the same rules in non-OECD members will be necessary.

1. It seems to us that many problems result from differences between companies to be taxed as transparent or not transparent.
2. We assume that countries are not willing to harmonize neither company law nor tax law preventing hybrid mismatches.
3. OECD rules may distort the competitiveness of countries accomplishing the rules.
4. Disadvantages for non-related parties and minority shareholders may occur.
5. Wide definitions lead to difficulties for jurisdictions and tax payers.
6. Different group taxation and timing differences must be acknowledged.
7. Double taxation has to be avoided.
8. Recapturing schemes when selling shares in later years, leading to capital gains taxation, must be acknowledged.
9. Linking rules may be difficult to handle and to administer.
10. Difficulties may be experienced by the legislator when drafting a rule which refers to details of foreign taxation. German experience shows that collateral damages seem to be almost unavoidable.

## II. Summary of Questions for consultation

### 1. Design of Hybrid Mismatch Rules

1. Are the objectives and design principles of the hybrid mismatch arrangements clear?

   P. 27 describes the criteria of hybrid mismatch rules, e. g.

   (a) operate to eliminate the mismatch without requiring the jurisdiction applying the rule to establish that it has ‘lost’ tax revenue under the arrangement;

   (e) minimize the disruption to existing domestic law;

   (i) be easy for tax authorities to administer.

   We wonder if it is possible to satisfy these requirements.

## 2. Hybrid Financial Instruments & Transfers

4. This document sets out two possible approaches to drafting a scoping rule and summarises the possible advantages and disadvantages. Are the advantages and disadvantages accurately described and are there any other disadvantages of the two approaches?

   (a) What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration?

   Bottom-up approach

   A disadvantage of this method is the necessity of clear definitions of related parties, parties acting together and structured arrangements.

   Even under national tax law and company law it is nearly impossible to find definitions being overwhelmingly accepted. Therefore it may be impossible to find them in an international legal surrounding.

   Top-down approach

   This approach would introduce a number of compliance concerns and information requirements.

   As mentioned in the paper this approach could exclude certain categories of instruments that posed a low or nil risk from a hybrid mismatch perspective, e.g. plain vanilla instruments at a market rate of interest.

   We wonder if it is possible to draw a clear line between hybrid mismatches and other financial instruments.

5. This part includes a number of examples:

   (a) What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties position.

   More tax compliance burdens may occur.

6. What definition could be used to capture the concept of widely-held or regularly traded whilst also addressing concerns that any exemption should not be available to related parties, parties acting in concert or parties to a structured arrangement (i.e. an arrangement designed to obtain the benefit of a mismatch)?

We think it is nearly impossible to find a definition being accepted in every country depending on different jurisdictions. For instance no generally accepted GAAR-clause has yet been found.

7. If the rule exempted certain traded instruments then how could it be drafted so that it still applied to structured arrangements?

   In this case: What does “structured arrangement” regarding these cases really mean?

**3. Hybrid Entity Payments**

4. Are there any related party structures where the hybrid entity may have difficulty in knowing or obtaining information about the position of the investor?

   Yes, espc. in group structures with many subsidiaries it may be nearly impossible to fulfill these information requirements.

**4. Imported Mismatches and Reverse Hybrids**

2. Is it clear what elements need to be present in order for the defensive rule neutralising reverse hybrids and imported mismatches to apply?

   The definitions are not clear, f. i. the taxpayer must be part of the same control group as the parties to the mismatch.

   We doubt whether a commonly accepted definition of “same control group” can be found.

**5. Further Technical Discussion and Examples**

1. Do these technical recommendations assist in understanding and applying the rules?

   A wide range of information requirements fulfilling the filing and information requirements are a huge burden to administrations and taxpayers.

BUSINESSEUROPE

OECD Centre on Tax
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2 May 2014

**Submitted by email: aggressivetaxplanning@oecd.org and taxtreaties@oecd.org**

**Comments on the OECD Public Discussion Draft entitled "BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements" 19 March 2014 – 2 May 2014**

Through its members, BUSINESSEUROPE represents 20 million European small, medium and large companies. BUSINESSEUROPE's members are 41 leading industrial and employers' federations from 35 European countries, working together since 1958 to achieve growth and competitiveness in Europe.

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled "BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements" 19 March 2014 – 2 May 2014" (hereinafter referred to as the Draft).

BUSINESSEUROPE supports the OECD's work to address mismatches with respect to hybrid instruments and hybrid entities. Unintended non-taxation should be addressed in order to ensure a level playing field and a coherent tax system. The aim should be to address such mismatches with a minimum impact on markets in general, the economy and genuine business activities. From a business perspective and as an overriding principle, group structures and financial flows should not primarily be steered by tax rules, whilst recognising that tax can and should play a part in how organisations operate and structure themselves.

It is important to underline that hybrid mismatches is a symptom of classification and characterisation differences in different jurisdictions' tax laws. While we support the work on eliminating such mismatches, it should be acknowledged that financial instruments and entities that may cause hybrid mismatches are, per se, not the problem. Such instruments and entities may in fact be very important for businesses in undertaking their activities. Thus, we maintain that it is the mismatch effect and not the instruments or entities themselves that should be addressed.

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It is of utmost importance to make a clear distinction between intended and un-intended non-taxation. In the Action Plan on Base Erosion and Profit Shifting, it is stated that “no or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it”. The distinction between intended and unintended non-taxation provides meaning to differences between tax efficiency and aggressive tax planning from a business point of view, and normal tax policy and harmful tax practices from a government point of view. Businesses should be allowed to respond to legitimate and intended tax initiatives without being accused of aggressive tax planning and governments need to agree on acceptable forms of tax competition.

If one country openly refrains from taxation (intended non-taxation), another country should not automatically be allowed to undo this effect by taxing the income. This is an issue of the allocation of taxing rights, which is particularly concerning in the third country setting (i.e., under the proposed imported mismatch rules). If that were to happen, the efficiency of the first country’s tax policy objectives would be undermined and tax revenues would de facto unjustifiably be exported to another country. It is important to address each situation, and distinguish this situation from one in which unintended non-taxation arises due to double deductions or lack of inclusion despite legal intent.

Consequently, any recommendation to address hybrid mismatches should be limited to target only unintended non-taxation. It should be recognised that the fact that a payment is not subject to tax in either jurisdiction in case of a cross border transaction does not by itself mean that it is a matter of BEPS.

The Draft seems to indicate that the risk of tax arbitrage as a result of hybrid mismatches is greater in transactions between related entities than between unrelated entities. Considering the fact that a significant portion of cross border transactions is between related entities it is important that the provisions are designed in such a way that genuine businesses do not need to assess whether there is a risk for hybrid mismatch in each and every cross border arrangement. If that were to be the case, it would increase the threshold for cross-border arrangements and it will definitely have a very negative impact on trade and investments. Such a scenario should not be the purpose of the BEPS project, but BUSINESSEUROPE is concerned that based on the Draft it could arise as an unintended consequence.

The main issue with respect to hybrid mismatch is tax arbitrage as a result of arrangements that involve two or more jurisdictions and where either duplicate deductions are granted with respect to the same payment, or where a deduction is granted without the inclusion of the same payment in the ordinary income of a party of the arrangement. It is, however, not recognized in the Draft that the mirror of this problem is the risk for double taxation. As a result of different classifications and characterizations, an arrangement may result in two jurisdictions denying deductions or requiring inclusion of the same payment in the ordinary income of more than one entity. Often, such cases of double taxation may be neutralized by tax treaties. This is

however not always the case. Furthermore, in light of the BEPS project, businesses are concerned that the risk for double taxation may increase significantly. At the same time, access to treaty benefits is likely to be limited as a result of the current work on Action 6 addressing so called treaty abuse.

Because of the potential for double taxation as a result of the proposed hybrid rules, we recommend that the enactment of the rules be clearly linked to the adoption of strong and expeditious dispute-resolution processes, including Mutual Agreement Procedures and binding arbitration for cross-border disputes.

Furthermore, BUSINESSEUROPE is very concerned about the complexity of the recommendations in the Draft. Under the recommendations for domestic laws, the taxpayer's deduction or inclusion is linked to whether that deduction or inclusion is granted or required in another jurisdiction. We are concerned that such an approach would impose a significant compliance burden on taxpayers, particularly if information is to be obtained from non-related entities and/or entities not under control. Taxpayers would be required to learn not only how the arrangement is to be treated in the tax law of their own jurisdiction, they would also have to understand the tax laws of the jurisdiction of their counterparties (and in some cases even more than one other jurisdiction). The tax treatment in each jurisdiction may by itself be unclear and difficult to predict. This approach is very complex and is in contrast with the design principles in para 27 in the Draft (in particular (h) "be workable for taxpayers and keep compliance burden at a minimum"). Consequently, we believe that the recommendations should be designed in such a way that the complexity is kept to a minimum.

The Draft recommends a two-step approach which may differ per category of hybrid mismatch. The recommended primary rule is supplemented by a secondary rule in case a primary rule is not adopted. In addition, further recommendations in relations to certain transactions are made. We worry that the two-step approach may, as result of two or more jurisdictions denying deduction or requiring inclusion of the same payment in the taxpayer's ordinary income, increase the risk of double taxation and add to the complexity.

We also note that the recommendations in general are not limited to abusive circumstances. This is in our opinion another reason for designing the rules in a manner that would keep the impact on genuine business activities to a minimum.

In this respect we also believe that the recommendations on hybrid mismatches should be coordinated with the other Action Points on CFC, interest deductibility and harmful tax practices. That way, interaction between the overall recommendations is ensured, while at the same time the impact across jurisdictions is balanced.

With respect to the proposal to amend Article 1 of the OECD Model Convention, BUSINESSEUROPE understands that there may be some cause for concern with respect to hybrid entities. We do however believe that this is best addressed through recommendations for more uniform domestic tax rules rather than amendments to the

OECD Model Convention. The initial and prime objective with tax treaties is and should continue to be to facilitate cross-border trade and investment through the allocation of taxing rights between countries and to provide for mechanisms to eliminate double-taxation. Consequently, tax treaties should not be overwhelmed with anti-abuse provisions that may undermine that purpose.

BUSINESSEUROPE would be willing to engage in a constructive dialogue with the OECD on the treatment of hybrids.

On behalf of the BUSINESSEUROPE Tax Policy Group

Yours sincerely,

James Watson
Director
Economics Department

**CBI and 100 Group RESPONSE TO THE OECD DISCUSSION DRAFT ON BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS**

1. The CBI and 100 Group are pleased to comment on the OECD's discussion draft on Action 2: neutralise the effects of hybrid mismatch arrangements, published on 19 March 2014.
2. As the UK's leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.
3. The 100 Group represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent almost 90% of the market capitalisation of the FTSE 100 group collectively employing over 7% of the UK workforce.

**General comments**

4. We support the comments issued through BIAC's response to the OECD discussion draft on BEPS action 2 dated 30 April 2014, however we wanted to take the opportunity to outline a number of supplementary comments that concern our joint memberships.
5. We commend the work of the OECD in producing a detailed and comprehensive discussion document, which clearly outlines the complex issues involved in hybrid mismatch arrangements. However, our key concern is that any measures to address this issue should be clearly targeted, proportionate to the perceived abuse and should not impose undue compliance burdens.
6. We therefore consider that the scope of the measures should be restricted to "profit shifting arrangements" between related parties, and should only apply to third parties where they facilitate or are a party to structured arrangements. In effect, this would limit the scope of the rules to an anti-abuse rather than a wide anti-avoidance rule.
7. We also note the considerable overlap between Action 2 and the workstreams on CFC rules and interest deductibility, which are not due to report until 2015. We believe it is important that the work on these areas should be fully co-ordinated, so the actions taken forward in 2014 should be revisited once the 2015 work is concluded.
8. As part of this process, agreeing common definitions of the key terms should not be neglected. These definitions need to apply across a wide range of tax jurisdictions with very different tax regimes giving rise to possible issues for both taxpayers and tax administrations.
9. It is important to keep in mind the remarkable complexity of these proposed rules. The proposals themselves are complex and the interactions covered are also complex. This is particularly apparent in the Imported Mismatch rules. To ensure the allocation of taxing rights is correct will require an enquiry by a tax authority as to the treatment of an item of income under two other different tax regimes. We believe that the Import Mismatch rules should be omitted from this Action Plan until it is clear how the rules will work in practice.
10. More generally, the piecemeal adoption of hybrid mismatch rules by different countries could lead to taxpayers facing complex and rapidly-changing compliance burdens. We recommend that a clear process be established to ensure that consistent rules are adopted, in a co-ordinated fashion.

**Hybrid instruments and transfers**

11. It is important to note that BEPS action 2 is not intended to address sovereign tax policy choices. Where a government has decided to grant a tax incentive, it is legitimate for businesses to make use of

it. For example, the Brazilian interest in net equity (IONE) is very similar in substance to regimes that grant a tax deduction for invested equity, so should clearly be outside the scope of any hybrids rules. Similarly the Belgium notional interest deduction (NID) regime that treats part of a company's equity like debt is distinct from a taxpayer structuring an instrument to achieve the same result.

12. The approach should be to set out clear criteria for including instruments within the rules. Although subjective this might include a "main purpose" or "main benefit" test of the profit shifting arrangements. For example, a gateway test could be used to apply the rules where the purpose of the arrangement is to secure a tax advantage in either of the jurisdictions.
13. It would be appropriate to include a specific anti-abuse rule, so that any attempt to structure an instrument to fall outside the scope of the hybrid rules would fail.
14. We are strongly of the view that a "bottom-up" approach is to be preferred. The key problem with a "top down" approach is that a lot of routine transactions could inadvertently fall within the scope of the rules. For example, many corporates (not just in the financial sector) use a group cash pooling system. If a subsidiary has a routine banking arrangement with the same bank, this could be regarded as an "arrangement" and so detailed enquiries would have to be made to ensure that there was no element of a hybrid mismatch.
15. A bottom up approach is essential to enable the measures to be targeted at abusive behaviour. This is because, absent global harmonisation of tax systems, there will always be mismatches arising in commercial situations.
16. For the avoidance of doubt, instruments which are widely held and traded should not be within the scope of any rules, since the risk of these being part of a structured arrangement is low.

**Regulatory capital**

17. In certain industries, particularly financially regulated ones such as banks and insurance companies, there are already considerable regulatory restrictions relating to the issuance of capital instruments. The addition of complex tax rules in this area will add to compliance burdens and could distort commercial decisions.
18. In particular, regulators are increasingly encouraging financial institutions to raise capital at the level of a top-tier holding company, and then use intercompany funding to move the capital into operating companies.
19. We therefore consider that instruments issued primarily to meet regulatory capital requirements should not be subject to hybrid mismatch rules. We are aware that the ABI have outlined why regulatory hybrid capital should be carved out and support this position.

**Joint Ventures**

20. Joint ventures take many forms, ranging from contractual joint ventures to legal entity partnerships and jointly owned incorporated entities. In many cases, one partner in a joint venture will have no information about the tax position of a joint venture partner.
21. The definition of a related party should refer to a significant element of control, by reference to economic interest or voting power. We would suggest that 40% would be an appropriate threshold, rather than the 10% put forward in the Discussion Draft.

**BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Recommendations for domestic laws)**
**Response by the Chartered Institute of Taxation**

## 1 Introduction

1.1 We refer to the Public Discussion Draft published on 19 March 2014 which discusses BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements, focussing on recommendations for domestic laws (Consultation Document).

1.2 The CIOT recognises that actions in regard to hybrid instruments and hybrid entities form a central part of the BEPS programme. Hybrid mismatches can lead to a reduction in the overall tax burden of multi-national enterprises in the absence of a commercial economic loss and many other tax-payers question why this should be permitted. Hybrids can thus cause a loss of confidence in the international tax system.

1.3 Hybrids are not always used deliberately to lower a tax burden, and in some cases a reduction in tax may be fortuitous. However, governments would generally seek to eliminate fortuitous non-taxation in a domestic context, so there is no reason why the OECD should not look to actions to eliminate non-taxation from hybrids generally.

1.4 Hybrids may also give rise to double taxation, which can also cause a lack of confidence in the international tax system from those suffering such double taxation. Measures to eliminate non-taxation should be balanced by measures to eliminate double taxation.

1.5 Accordingly, we believe that the OECD should look to see if it can introduce rules that not only eliminate mis-matches, but also give rise to single taxation in what would otherwise be double taxation cases; the goal should be universal single taxation.

1.6 Furthermore, we welcome the fact that the OECD has noted that hybrid mismatches arise as a result of governments taking different stances on the taxation of instruments or entities, and that it is frequently difficult or impossible to identify which government has suffered loss. As in much of the BEPS project, this is not a case of

tax avoidance as previously understood; there can be no avoidance where there is no intent to tax in the first place. The tools to deal with non-taxation will not be the same as those used for avoidance. This should be remembered in particular where penalty and interest regimes are involved.

1.7 The proposed recommendations, although they address the "problem" of hybrids from a theoretical standpoint, give rise to surprising outcomes. For example, the "defensive rule" for a D/NI hybrid entity payment situation leads to a state effectively over-riding its own otherwise settled treatment of a transaction, and expanding its tax base.

1.8 In our view, the ideal outcome from the OECD's work on hybrids would be for greater harmony amongst states in relation to taxing items as debt or equity and in entity classification; i.e. states themselves addressing the anomalies giving rise to hybrid situations. We note that the OECD feels that such harmonisation is unlikely. However, we would suggest that the first recommendation of the OECD should be for states to change their rules in these areas, with the tools as outlined in the document being held in reserve should such changes not be forthcoming.

1.9 Should rules of the type proposed in the document be necessary, there should be thresholds on application to take SME's out of the rules. We note that if a "universal single taxation" approach is adopted taking SME's out of the rules could leave them in a double taxation position, but we believe the number of cases where this may arise is likely to be small.

1.10 A key point in our view is that international co-operation is paramount in addressing the issue of hybrids. If not all states adopt measures to ensure single taxation of hybrids, there is potential for substantial tax advantages to remain for companies resident in those states. This could lead to distorted tax competition. We anticipate this may be a particular issue with hybrids involving entity classification, where it may be difficult for certain states to change domestic rules. There is thus a danger of a situation where some states initiate partial measures, some none at all and some comprehensive measures, leaving continuing opportunities for companies resident in the states with no or partial measures to receive a "subsidy" from the international tax system not available to those in states where the measures are comprehensive.

## 2 Section II: Design of mismatch rules

2.1 We are asked at the end of Section II (in Box 1. on page 14) whether the objectives and design principles of the hybrid mismatch arrangements are clear or whether further clarification is required.

2.2 We understand that there may be concern over certain intragroup financing arrangements. However, we do not believe that transactions between third parties should be targeted where they are not part of a wider group scheme.

2.3 We note that there is no motive test being offered in the design principles (discussed in paragraph 4 of the Consultation Document). Whilst this is presented as a way of keeping the application of the rules simple (for example not requiring a jurisdiction to prove it has lost revenue), it has the potential to greatly increase the compliance burden, as rather than having to prove that there was no 'abuse' involved in a transaction, an entity or group may now need to map each and every hybrid transaction through its lifetime.

## 3 Section IV: Hybrid Financial Instruments and Transfers

3.1 *Summary of Recommendations*

3.2 The proposals in the Consultation Document are concerned with the development of linking rules. These are multi-layered and, it is suggested, will be entitled to apply in a priority order (paragraph 34).

3.3 However, the hybrid financial instrument rule is not clear on whether it is the payee or the payer who has the primary responsibility for deciding whether or not the rule should be applied in the other territory. For example, Recommendation a) on page 25 of the Consultation Document suggests that if the payee does not include the payment as ordinary income then a deduction should be denied for the payer. In other words, the treatment for the payer is determined by the application of the rule by the payee. However, at paragraph 108 (b), it seems that the payer is required to apply the 'primary rule' of deductibility or otherwise of the payment, and once this is established then the payee determines whether or to what extent the income should be recognised as ordinary income. It would be helpful to have some further clarity on where the onus or primary responsibility should lie.

3.4 With respect to repos in particular, repos originated as a mechanism to allow unlicensed moneylenders to conduct their trade without being caught by what were then the Banking Acts. In other words, they were a form of secured lending as the security was effectively the asset that was sold and bought back. With that as an economic background, it makes more sense to require income inclusion than it does to deny a deduction if the economic cost of the transaction is being borne in the payer jurisdiction. The Consultation Document says (very pragmatically) that it does not want a rule that produces lengthy enquiries into which jurisdiction has lost out from the hybrid instrument but that does not mean that it necessarily follows that denial of deduction should be the primary rule and income inclusion the back-up rule. We note that the amendments to the EU Parent/Subsidiary Directive prioritise income inclusion. We think it is essential that any new rules should not apply to the large third party repo and stock-lending markets – the potential for market disruption would otherwise be very significant.

3.5 We assume that the purpose of the layering is to allow counteraction by one of the affected jurisdictions under a defensive rule even when the other jurisdiction has decided to be taxpayer friendly and not implement the OECD recommendations. Whilst this may lead to the single taxation of hybrids, it is worth noting that this is a radical concept; one jurisdiction has taken a deliberate policy decision not to tax something or to tax a fact pattern in a manner which produces a low tax result, and a counterparty jurisdiction is being allowed to benefit from additional tax revenues, that would not accrue to it in other circumstances.

3.6 *Technical Discussion*

3.7 Paragraph 84 of the Consultation Document suggests that jurisdictions should consider modifying their definition of 'dividend'. We suggest that it would be difficult and unhelpful for wider company law purposes for domestic law definitions of 'dividend' to be altered. It would be more appropriate, as also suggested, for jurisdictions with dividend exemption rules, to modify the eligibility of those exemptions, for this purpose.

3.8 Paragraph 94 of the Consultation Document says that exemptions granted to entities

such as charities should not be caught by the hybrid financial instrument rule because these exemptions are attributable to a particular characteristic of the taxpayer. However, paragraph 97 then appears to contradict this – in that it says the rule should apply to mismatches attributable to a hybrid element in the instrument itself. Clarification on this point would be helpful; we cannot see it is right to impose taxation on a charity, pension fund or other tax-exempt entity.

3.9 With regard to whether the outcome of the rules' operation is clear, the intention of the outcome is clear to the extent that it is designed to capture and neutralise DD or D/NI transactions – however we are concerned that the rules could give rise to significant compliance burden. The compliance burden for tax authorities and for taxpayers is another reason why we believe the Top Down approach should be rejected.

3.10 Paragraph 88 suggests that timing differences will not in themselves bring into scope a financial instrument that would not otherwise be caught. However, it is not clear whether the treatment for both payer and payee should be determined at the beginning or the end of the life of the instrument. What would happen in the event that the rules in one or other jurisdiction changed during the life of the instrument? Are any grandfathering provisions being considered?

3.11 *Scope*

3.12 ***Hybrid financial instrument rule does not apply to payments that benefit from a dividend exemption***

3.13 With regard to Paragraphs 113 to 115 of the Consultation Document, we suggest that it is excessive to recommend that dividend exemptions should be disallowed whenever the payment is deductible under the laws of the issuer's jurisdiction and also that there should be no limitation on the scope of this recommendation.

3.14 A number of jurisdictions allow deductions for dividend payments in specified circumstances as an investment incentive. Additionally, some foreign tax systems may operate in a different way from the usual system whereby they may allow dividend payments as a corporate tax deduction and impose corporate taxes in a different way, such as primarily by way of dividend withholding taxes. In such cases excluding the payment from dividend exemption in the recipient country would effectively deny the companies involved the benefit of the investment incentives or be incompatible with the nature of some corporate tax regimes by imposing additional tax burdens in other countries.

3.15 ***Overall approach to scope***

3.16 We agree with the last sentence of paragraph 117. However, before considering the bottom up or top down approaches, we suggest there should be further consideration as to what the rule is intended to catch.

3.17 Paragraph 121 sets out the current thinking as to what the hybrid instrument rule should catch. However, the categories identified in paragraph 121 are very broad brush and could (even on a bottom up style of drafting) catch non-abusive transactions. We are not clear about the policy reasons behind these broad categories.

3.18 In paragraph (a) instruments held by "related parties" will always be caught, even if, say, the transactions are identical to ones which would not be in scope if they were widely held. We are not clear why this should be the case. What is the position of

parent company instruments held in a trading companies dealing book or insurance portfolio? Would it make a difference if these instruments are normally widely held/traded and if not, why not?

3.19 Similarly "structured arrangements" are always caught, except in certain circumstances as in the case of regulatory capital (paragraph 158 et seq.) or some deferred consideration arrangements (paragraph 133). We understand that the OECD have avoided a motive rule because of complications with proof etc, however it is interesting to note that at paragraph 121 (b), the consideration of whether or not something has been 'designed to produce a mismatch' implies a motive.

3.20 We suggest that paragraph 121 (c) regarding widely held instruments being outside the scope of the rule could cause confusion with repos and exchangeable debt where the underlying/deliverable is widely traded.

3.21 The related party threshold is set at 10% although paragraph 126 asserts that "parties that share a significant degree of common ownership or control can be expected to identify and negotiate an appropriate allocation of risk" – this not likely to be the case for a 10% shareholder. We suggest that a 10% investment is too low a threshold for a 'related party'. It is strongly recommended that this percentage is increased to greater than 50%, which is the normal definition of control.

3.22 We suggest that the test for the concert party rule ("regularly acts in accordance with") will be hard for companies to apply in practice. Rule of this nature in the UK frequently causes uncertainty in practice.

3.23 In terms of widely held/regularly traded, if this concept is used (and the policy reasons for it are not clear), exemptions would be needed for situations where a company was the subject of a bid or where trading was suspended for some reason. What would be the position if the instrument was listed and a market maker offered a pricing but trading volumes merely happened to be thin in the reference period? Would an instrument that had previously been outside scope come within the scope of the hybrid mismatch rules if the issuer was in financial trouble and a bond trustee or other creditors representative was acting? What would be the position if otherwise actively traded instrument were bought into the group or into treasury to support the price or with a view to their cancellation? What happens if part of an issue is bought back so that a person who did not have 10% pre-buyback then has more than 10%?

3.24 Paragraph 157 is part of a discussion on 'traded instruments'.

3.25 The last sentence of paragraph 157 indicates that any exception from the hybrid rules for traded instruments should be excluded in those cases where the transfer is to a related party or is part of a structured arrangement designed to engineer a hybrid mismatch. This is much too broad an exclusion, particularly with regard to transfers to related parties. Such transfers are already subject to extensive anti abuse rules, such as transfer pricing provisions, thin capitalisation provisions and rules excluding reliefs where there is a non-commercial purpose. There are no grounds for excluding a traded instrument exemption just because the transaction is with a related party. Such a rule would have a major adverse impact on normal commercial transactions between related companies.

3.26 Overall, we favour the bottom up approach as this seems to give a more measured approach to achieving the same objective.

3.27 With regard to the commercial and legal difficulties where parties to an arrangement are unconnected and have no knowledge of the counterparties' position, there is no

obligation to provide what could be sensitive information to an unconnected party. Therefore the provision of such information by one party to another may need to be specifically built into the terms and conditions of entering into a transaction or issuing a particular type of instrument. However, as we note above, it is not clear to us why transactions between third parties should be targeted where they are not part of a wider group scheme.

3.28 With regards to banking groups and regulatory capital, we note that insurance groups are also required to meet capital adequacy requirements by insurance industry regulators and so are subject to similar constraints as the banking industry. Debt instruments which are able to be included for capital/solvency purposes will have certain features relating to interest deferral and loss absorbency which make them similar to equity. These features are mandated by local regulators, and such requirements will become more stringent upon the introduction of Solvency II in 2016.

3.29 These debt instruments have not been designed with tax mismatch in mind, but instead are required to ensure that the insurance industry is able to meet its capital adequacy requirements effectively and efficiently.

3.30 Over the last 10 years, insurers in EU countries in particular have been required to hold greater levels of capital in order to strengthen their ability to withstand market shocks or unexpected losses. The holding of regulatory hybrid capital has been encouraged as a means of providing a cost effective way to achieve this and to raise non-dilutive capital. If the ability to deduct interest on these is denied then there is a concern that EU insurers will be at a competitive disadvantage with non-EU insurers.

3.31 For insurance groups, it is quite common for hybrid regulatory capital instruments to be issued externally at top company level and then passed down the group – however this is not always the case. The decision on where to issue the instruments will depend on a number of commercial considerations; for example the recognition of regulatory capital by different local regulators, a need to access a particular capital market to benefit from certain terms and conditions being offered at a certain point in time and the extent to which there is cash already available in the top company or elsewhere in the group.

3.32 Some groups may have a dedicated Group Treasury company which would be used to obtain better market rates than one of the regulated intermediate holdings companies. After the introduction of the UK's new CFC regime, a number of groups restructured their group treasury functions in order to be able to access the preferential tax rates being offered.

3.33 Hybrid regulatory capital instruments will typically be passed down a group on a like for like basis – but not always. The facts and circumstances of the group will ultimately determine the flow of funds.

3.34 Hybrid regulatory capital instruments may have similar or same form as other instruments – however it is the purpose for which they are being held (to support regulatory capital requirements) that should be sufficient to allow them to be excluded from scope. We acknowledge that obtaining multiple deductions within a group should not be protected.

## 4 Section V: Hybrid Entity payments

4.1 Payments should only be hybrid if they are deductible and actually claimed and allowed as deductions by the relevant tax authority. For example, if the UK is refusing a deduction under an anti-avoidance rule, the other state should wait and see whether there is an effective deduction before requiring back-up income inclusion.

## 5 Section VI: Imported mismatches and reverse hybrids - Summary of recommendations

5.1 Recommendations here go far beyond anything reasonably required to deal with abuse and would adversely impact many normal and commercial operations.

We recommend that the OECD rethink whether these proposals are in fact needed as outlined in the Discussion draft.

In summary, it is recommended that:

(1) Countries have CFC rules, foreign investment fund (FIF) rules or other provisions which tax on a current basis income of residents accrued in offshore investment structures;

(2) Entities or arrangements that are transparent or partially transparent under the laws of an " intermediary " jurisdiction to be treated as taxable there;

(3) Payments to reverse hybrids and imported mismatch arrangements should be disallowed as deductions in the payer jurisdiction if it results in a no taxation outcome or is offset by expenditure incurred under a hybrid mismatch arrangement and the taxpayer is part of the same control group or is party to an avoidance arrangement.

5.2 With regard to paragraph (1) above, this would go far beyond the CFC or FIF legislation of most countries. Additionally, a substantial number of countries have decided that CFC legislation is inappropriate for them. In the UK, for example, the CFC legislation was recently comprehensively reformed both to prevent tax avoidance and provide a system which would allow international business to operate efficiently. EU Member States need to comply with the freedom of establishment rule included in the TFEU which limits the scope of CFC rules.

5.3 Paragraph (2) above would require legislation contrary to the basic approach of many countries to the taxation of investment vehicles, such as partnerships and investment funds.

5.4 Finally paragraph (3) above would be entirely unnecessary in the UK and many other countries as the deduction of payments is already covered by anti-avoidance provisions relating to transfer pricing, thin capitalisation and commercial purpose tests.

5.5 The UK already has legislation whose purpose is to counter the use of such hybrids for tax avoidance, namely the ‘anti-arbitrage’ legislation of 2005. Furthermore, some of its treaties (in particular, the 2001 treaty with the United States) contain provisions to deal with hybrids.

## 6 The Chartered Institute of Taxation

6.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

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The CIOT's 17,000 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation
1 May 2014

Chartered Institute of Taxation

Excellence in Taxation

**BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements (Treaty Issues)**
**Response by the Chartered Institute of Taxation**

## 1 Introduction

1.1 We refer to the Public Discussion Draft published on 19 March 2014 which discusses BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements, focussing on treaty issues (Discussion Draft).

1.2 The CIOT recognises that actions in regard to hybrid instruments and hybrid entities form a central part of the BEPS programme. Hybrid mismatches can lead to a reduction in the overall tax burden of multi-national enterprises in the absence of a commercial economic loss and many other tax-payers question why this should be permitted. Hybrids can thus cause a loss of confidence in the international tax system.

1.3 Hybrids are not always used deliberately to lower a tax burden, and in some cases a reduction in tax may be fortuitous. However, governments would generally seek to eliminate fortuitous non-taxation in a domestic context, so there is no reason why the OECD should not look to actions to eliminate non-taxation from hybrids generally.

1.4 Hybrids may also give rise to double taxation, which can also cause a lack of confidence in the international tax system from those suffering such double taxation. Measures to eliminate non-taxation should be balanced by measures to eliminate double taxation.

1.5 Accordingly, we believe that the OECD should look to see if it can introduce rules that not only eliminate mis-matches, but also give rise to single taxation in what would otherwise be double taxation cases; the goal should be universal single taxation.

1.6 Furthermore, we welcome the fact that the OECD has noted that hybrid mismatches arise as a result of governments taking different stances on the taxation of instruments or entities, and that it is frequently difficult or impossible to identify which government has suffered loss. As in much of the BEPS project, this is not a case of tax avoidance as previously understood; there can be no avoidance where there is no intent to tax in the first place. The tools to deal with non-taxation will not be the

same as those used for avoidance. This should be remembered in particular where penalty and interest regimes are involved; and, given such tools may be complex, there should be thresholds on application to take SME's out of the rules. We note that if a 'universal single taxation' approach is adopted taking SME's out of the rules could leave them in a double taxation position, but we believe the number of cases where this may arise is likely to be small.

1.7 A key point in our view is that international co-operation is paramount in addressing the issue of hybrids. If not all states adopt measures to ensure single taxation of hybrids, there is potential for substantial tax advantages to remain for companies resident in those states. This could lead to distorted tax competition. We anticipate this may be a particular issue with hybrids involving entity classification, where it may be difficult for certain states to change domestic rules. There is thus a danger of a situation where some states initiate partial measures, some none at all and some comprehensive measures, leaving continuing opportunities for companies resident in the states with no or partial measures to receive a 'subsidy' from the international tax system not available to those in states where the measures are comprehensive.

1.8 It is important to ensure that international trade is not inhibited by double taxation, or the fear of double taxation. The benefits arising from tax treaties in facilitating international trade and investment should not be forgotten; and facilitating international trade and investment should also continue to be a fundamental aim of the work in this area.

## 2 Dual resident entities

2.1 The Discussion Draft refers to the proposed change to Article 4(3) of the OECD Model Tax Convention included in the Tax Treaty Abuse Discussion Draft.

2.2 We repeat our comments made in our response to that discussion document. The proposed approach undermines legal certainty and the rule of law by placing the matter within the hands of the competent authorities without real guidelines or rules for them to apply. The mere assertion that there have been cases involving avoidance is insufficient to displace a legal rule with administrative power. The proposal assumes that the tie-breaker rule ought to be aimed primarily at preventing abuse and not at resolving double taxation. The two should be separated. No actual abuse is identified or explained. The problem should be identified and, if it exists, a solution may be found.

2.3 We think this issue would be best addressed by a recommendation for domestic legislation, such as that used in the UK. The primary rule for a UK-incorporated company is that it is resident for tax purposes in the UK. However, where residence is allocated to another country under a treaty, the company is automatically removed from UK residence. The result is that dual residence is avoided in a more straightforward manner.

2.4 Further, going through a competent authority process tends to be slow and expensive and there is no higher authority to give 'case directions' to control the process or to deal with the situation where the competent authorities do not agree with each other (and the more that treaties are expanded by the BEPS process, the more likely different interpretations in different jurisdictions and/or procedural break-downs become). This is principally why we would advocate sufficient and clear criteria in any LOB provision: so that the tie-breaker process is only required as a last resort and is not the primary route to resolve issues.

2.5 A sound principle based approach would involve reverting to the discussion in the 2003 paper on company residence and the communication revolution to consider whether the current single factor test continues to be appropriate in the 21st century.

2.6 Previously we have had a central control and management test which from a corporate point of view maps to things that the board does (or ought to do if its functions are not usurped) and an effective management test which can be regarded as the things you would expect executive management to do. The proposals seem to be heading for something that amalgamates the two as it suggests the need to look at the actions of directors and of executives and governing law. Such an approach would give rise to considerable uncertainty.

2.7 The relationship between these proposals and the proposed saving clause is unsatisfactory because it easily leads to double taxation.

## 3 Recommendations

3.1 The new proposals for treaty benefits for entities that are treated as wholly or partly transparent in one jurisdiction but not the other needs to consider the possibility that the non 'State B' participant is in a treaty jurisdiction (call it 'State C').

3.2 So the example in paragraph 26.7 of the draft new Commentary needs to explain what should happen if the other member is resident in State C and there is a State A/ State C treaty that is at least as good as the State A/State B treaty, or which provides some benefits but not quite such good ones.

3.3 What happens if State C does not regard the State B entity as fiscally transparent? If the State A/State B treaty does not apply to the State C resident, do you then fall back to the treaty between State A and State C which neither of them considers is applicable? Does that mean that the unlucky member of the State B entity who happens to be resident in State C get no treaty benefit – or should the OECD be recommending a second layer of treaty changes to deal with this issue?

3.4 Treaties should contain provisions for procedures where two domestic systems attempt to apply mis-match counteractions.

## 4 The Chartered Institute of Taxation

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The Chartered Institute of Taxation
1 May 2014

CONFEDERATION FISCALE EUROPEENNE

# Opinion Statement FC 9/2014 of the CFE on the two OECD Discussion Drafts: Neutralise the effects of hybrid mismatch arrangements (BEPS Action 2)

**Prepared by the CFE Fiscal Committee**

**Submitted to the OECD**

**in May 2014**

*CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 32 professional organisations from 25 European countries (21 EU member states) with 180,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe.*
*CFE is registered in the EU Transparency Register (no. 3543183647-05).*

*We will be pleased to answer any questions you may have concerning CFE's comments outlined below. For further information, please contact Mr. Piergiorgio Valente, Chairman of the CFE Fiscal Committee or Rudolf Reibel, Fiscal and Professional Affairs Officer of the CFE, at brusselsoffice@cfe-eutax.org.*

*Sincerely yours,*
*Confédération Fiscale Européenne*

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On 19 March 2014, the OECD released two Discussion Drafts on neutralising the effect of hybrid mismatch arrangements for public comment, titled (1) Recommendations for Domestic Laws[1], and (2) Treaty Aspects of the Work on Action 2 of the BEPS Action Plan[2].

**General comments:**

The two Discussion Drafts showed two possible approaches to addressing hybrid mismatches: Under a top down approach the rules would apply to all transactions involving hybrid instruments with certain limited exceptions. Under a bottom-up approach the rules would apply to instruments held between related parties and instruments entered into as part of a tax-motivated "structured" arrangement. We understand from a recent statement of Pascal Saint-Amans[3] that the OECD favours the bottom-up approach. We welcome this more targeted approach.

In our view, the ideal solution would be common, internationally agreed concepts of debt and equity.

The current suggested measures are complex and would be difficult to implement. For example there are different rules which apply to related- and unrelated party transactions. Apart from an increase in compliance costs, we are particularly worried about the creation of new potential situations of double taxation. To reach a solution, the OECD should work towards mandatory binding arbitration and more effective MAPs.

**EU Treaty freedoms:**

As the majority of OECD and G20 countries are EU member states, bound by the fundamental freedoms in the Treaty on the Functioning of the EU, notably the free movement of capital (Art.63 TFEU), and their interpretation by the EU Court of Justice, the

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[1] http://www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf.
[2] http://www.oecd.org/ctp/treaties/hybrid-mismatch-arrangements-discussion-draft-treaty-issues-march-2014.pdf.
[3] IFS/ETPF Conference in London on Monday 28 April on *International Taxation: Base erosion, profit shifting and distortions to real activity.*

success of any OECD solution to solve BEPS caused by hybrid mismatches will depend to a great extent on the compatibility of such a solution with the EU fundamental freedoms.

**Specific comments:**

**Discussion Draft 2, Chapter 1: Ensuring that dual resident entities are not used to obtain the benefits of treaties unduly**

The Discussion Draft proposes solving cases of dual treaty residence on a case-by-case basis rather than by reference to the current rule which uses the place of effective management of entities. The proposed wording for Article 4 (3) requires always having a mutual agreement between the contracting states.

Two major concerns arise from the consequences of this proposed requirement: (i) additional unnecessary burden on the tax authorities of the two contracting states: the mutual agreement procedure should be used as a last alternative, not first alternative; and (ii) potentially unjust to the taxpayer being subject to double taxation without fault and due to circumstances unrelated to his behaviour and beyond his influence.

Additionally, whatever the solution adopted by the OECD, it is crucial that there is simultaneous adoption by all states. In situations where an entity is resident of two states, one of which has adopted the above proposal and the second (for example, in which the entity's effective management is established) has not, the taxpayer will face double-taxation with no possibility of reprieve. Whilst it is agreed that double non-taxation is not the purpose of the treaty, double taxation is also not an acceptable result.

**Discussion Draft 2, Chapter 2: Ensuring that transparent entities are not used to obtain the benefits of treaties unduly**

The Discussion Draft proposes the addition of an Article 1 (2) to the Model Convention to ensure that income of transparent entities other than partnerships is treated, for the purposes of the Model Convention, in accordance with the principles of the Partnership Report.

Whilst the concept of addressing transparent entities which do not fall within the Partnership Report is understandable, this should not be addressed in Article 1 of the Model Convention, but either in the relevant provisions relating to income (Articles 6-21) or in a separate report regarding the taxation of entities that are fully or partly transparent.

Confusingly, the proposed Article 1 (2) is not referring to the tax treatment of *persons* (as the title to and current wording to Article 1 does), but refers to the taxation of the *income* (see for example paragraph 26.12 of the proposed commentary).

Moreover, from the wording of the said proposed Article 1 (2), it seems possible to envisage a situation of double taxation: Where a country A considers an entity fully/partly transparent and still taxes a part of that income, the treaty would not restrict country B from also taxing this income. The wording is very ambiguous and if the "transparent" state taxes a part of the income, double taxation could arise:
"*...income derived by or through an entity [...] that is treated as [...] partly fiscally transparent under the tax law of either Contracting State* [State A] *shall be considered to be income of a*

*resident of **a** Contracting State but only to the extent that the **income** is treated, for purposes of taxation by that State* [A or B], *as the income of a resident of that State* [A or B]."

There is no clear reference to either of the contracting states, and thus no limitation as to whether the income derived shall be considered to be income of <u>that</u> contracting state or <u>the other</u> contracting state. If an entity is <u>partly</u> transparent, it is likely still to be considered a resident of a contracting state.

**Discussion Draft 2, Chapter 3: Interaction between the recommendations included in the WP11 Discussion Draft and the provisions of tax treaties**

The WP 11 Discussion Draft includes the following two recommendations for domestic implementation by the residence state:

- *"Any jurisdiction that grants an exemption for dividends under domestic law should deny the benefit of such exemption if such dividends are deductible in the payer State.*
- *Any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should introduce rules that would restrict the benefit of such relief in proportion to the net taxable income under the arrangement".*

These conditions are very difficult to prove, making these recommendations extremely burdensome in practice, as they require the tax authorities involved to check and confirm the tax treatment of the relevant instrument in the other contracting state. If this provision was adopted as proposed, it will be extremely difficult to implement it in such a way to make it reasonably effective in practice.

The proposed provisions also result in possible withholding tax obligations imposed on a resident company with respect to dividends paid to non-resident shareholders, but not with respect to dividends paid to resident shareholders, in other words it discriminates against non-resident shareholders. As mentioned above, any BEPS solution should comply with the EU fundamental freedoms and Directives.

Confederation of Indian Industry

# Neutralize the effects of Hybrid Mismatch Arrangements – Concerns and Recommendation

A REPRESENTATION

May 2014

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# BEPS: Action 2 – Neutralize the Effects of Hybrid Mismatch Arrangements – Concerns and Recommendation

## Background

On March 19, 2014, the Organization for Economic Co-operation and Development ('OECD') released two discussion drafts for public consultation on the topic - 'Neutralize the effects of Hybrid Mismatch Arrangements". The first discussion draft makes recommendations for harmonization of domestic tax laws of respective countries for eliminating hybrid mismatch. The second document discusses the effect these rules would have on the Model Tax Convention and proposes changes to the Convention to clarify treatment of hybrid entities. This is one of the 15 action plans recognized by OECD for addressing the issue of Base Erosion and Profit Shifting ('BEPS') practices adopted by Multinational Enterprises (MNEs). The concern regarding BEPS was first highlighted by G20 lead of nations in 2011 and India being a part of G20 nations supports the OECD work on BEPS.

The draft reports describe 'hybrid mismatch arrangements' as being the result of difference in the characterization of an entity or arrangement under the laws of two or more tax jurisdictions that result in a mismatch in tax outcomes. The mismatch arrangements targeted in the reports are those that result in a lower aggregate tax burden for the parties involved. The OECD considers these arrangements to harm competition, economic efficiency, transparency and fairness.

The discussion draft recommends 'linking rules' within domestic legislation; a primary rule, to apply whenever a mismatch arises and, a secondary rule, to apply in circumstances, where the primary rule does not apply. This approach aims to neutralize the hybrid mismatch on a standalone basis (ie within the domestic law), without reliance on counterparty jurisdictions. To avoid double taxation, a mechanism operates to switch-off the effect of one rule where there is a rule in the counterparty jurisdiction which addresses the mismatch. The ability of tax authorities and taxpayers to obtain sufficient information to conclude whether a structure falls within the definition of a hybrid mismatch arrangement will vary depending on a number of different factors including whether the counterparty is a related or third party.

With respect to treaty aspects, the draft deals with issues relating to dual resident entities, includes proposal for new treaty provision for dealing with transparent entities and provides guidance for aligning the recommendations provided in the first part relating to domestic tax laws with the tax treaty provisions.

We recognize the efforts of G20 along with the OECD towards addressing the issues of hybrid mismatch arrangements. However, in view of the existing Indian tax system and the legal and economic environment in India, we foresee certain practical challenges with regard to the cross border transactions and implementation in the present form for companies operating in India. Accordingly, we wish to bring to notice the following challenges and recommendation for your kind consideration.

## Amendment to domestic law

***Concerns***

The discussion draft attempts to address the issue of hybrid mismatch arrangements by carrying out suitable amendments to the domestic laws of respective countries. One of the challenges with hybrids is the determination of the country that is being disadvantaged. The OECD intends to proceed on the basis that the issue of hybrids should be addressed on an overall basis without specifically focusing on individual countries that are involved. Accordingly, the OECD proposals are likely to impact significant number of hybrid financing arrangements between countries.

Considering the changes are proposed to be effected by amending the respective domestic laws, one of the main challenges in this regard would be the need to achieve uniformity in such changes. Since every country is likely to have a different approach in respect of the issues involved, the realignment of domestic laws could be an uphill task. Also, there is a requirement for consistency with respect to the tax policy of most countries to encourage economic growth and attract capital investment.

The impact of adoption of hybrid rules would be materially affected by the interpretation of tax treaties, which often prescribe beneficial tax rates when compared to the domestic tax laws. In view of this, there seems to be a requirement to link this Action point with the work on 'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances' under Action point 6.

***Recommendations***

(a) As the discussion draft focuses significantly on the changes in the domestic law, there could be huge challenge in terms of complying with varying provisions in multi- jurisdictional tax regimes. This could result in increased uncertainty on taxability with a clear risk of genesis of double taxation that may be difficult to overcome.

(b) In view of the above, it is suggested that the changes should be confined to tax treaties for addressing the hybrid mismatch concerns and the domestic laws should not ordinarily be targeted.

## Related Persons

The discussion draft recommends that the scope of hybrid financial instrument rule should apply to all kinds of mismatch that arises between related parties, without any exception. The draft proposes a relatively low threshold limit for laying down the test for related party status. As per the recommendation, two entities are related, if the first entity holds 10 percent or more investment in the other, either directly or in an indirect manner.

In the Indian context, two entities can be considered to be related, if one of the entities holds minimum 20 percent equity in the other entity. Accordingly, the Indian laws envisage a threshold limit of 20 percent for two entities to be considered as related to each other. None of the regulations prescribe a lower threshold limit for constituting related party.

Accordingly, one of the pertinent issues is the determination of appropriate threshold for classifying the transaction as related party transaction. The 10 percent threshold as prescribed in the discussion draft is relatively low as compared to the domestic law and would cover significant genuine transactions by portfolio investors within its ambit.

***Recommendations***

a) There is a need to realign the 'threshold limit' specified in the discussion draft with the threshold of 20 percent prescribed under the domestic law.

b) The legitimate transactions undertaken by portfolio investors operating at a low level may fall under the category of related party transactions, causing unwarranted hardship. The scope of related party transaction, therefore, needs to be narrowed down by prescribing a higher threshold.

## Compulsory Convertible Debentures

***Concerns***

The discussion draft targets those hybrid financial instruments (including transfers) where a deductible payment made for servicing a financial instrument by the payer is not treated as taxable income under the laws of the payee's jurisdiction.

The two principal mismatches identified are payments that are deductible under the laws of the payer and not included in the income of the recipient and payments that give rise to duplicate deduction of the same.

The draft illustrates an instance wherein a mismatch arises due to the reason that the financial instrument is treated by the issuer as debt (i.e. a claim against the issuer) and by the holder as equity (i.e. an interest in the issuer) in the respective jurisdictions. This difference in characterization often results in a payment of deductible interest by the issuer being treated as a dividend which is exempted from the charge to tax in the holder's jurisdiction or subject to some other form of equivalent tax relief.
In the Indian context, it is pertinent to note that the stringent Exchange Control Regulations prevent the issue of various instruments in India as specified in the discussion draft. Herein, attention is required to be placed on Compulsory Convertible Debentures (CCDs) which could render similar fiscal outcome as hybrid financial instruments. The discussion draft covers these kinds of CCDs within its scope.

***Recommendations***

a) India as a developing nation could face challenges in case interest deduction on CCDs is denied to the issuer company. Considering the need and importance to attract foreign investments for developing nations, the draft guidelines may exclude CCDs from its scope.

b) The guidelines relating to CCDs, which are relevant in the Indian context should be clearly laid out. In this context, it is important to consider the earlier recommendation regarding the changes to be carried out in the treaty laws entered into by countries, as opposed to the proposal to carry out changes in the domestic tax laws of each country.

Confederation of Indian Industry

The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, Government, and civil society, through advisory and consultative processes.

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VNO NCW

Submitted by e-mail:
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Subject
VNO-NCW comments on the OECD Discussion Draft regarding BEPS Action Point 2: Neutralise the Effects of Hybrid Mismatch Arrangements published on 19 March 2014

Reference number
14/10.708/Jla

The Hague
May 1, 2014

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Dear Mr. Pross,

The Confederation of Netherlands Industry and Employers VNO-NCW welcomes the opportunity to provide comments on the public consultation draft aimed at neutralizing the effects of hybrid mismatch arrangements (hereafter: Discussion Draft) that was published by the OECD on 19 March 2014.

1. VNO-NCW appreciates that the Discussion Draft starts out by defining the hybrid mismatch arrangements that the rules as set out in the Draft are supposed to target. This is of vital importance to secure that the rules are going to be both targeted and proportionate.

2. In our view the objective of the Discussion Draft can be clarified by combining the elements in paragraphs 16, 17 and 18. This means that measures should target only hybrid mismatch arrangements that *(1)* shift profits or permanently erode the tax base of a jurisdiction by *(2)* utilizing the hybrid element in the tax treatment of an entity or instrument to produce a mismatch in the tax outcome, and *(3)* are used solely for tax purposes and adjust only the tax outcomes under those arrangements.

3. Throughout the Discussion Draft different definitions seem to be applied. For instance, in paragraph 60 a much wider definition is proposed than the wording of the Discussion Draft in paragraphs 16, 17 and 18. The definitions used should be aligned with the combined elements as suggested above under 2.

4. VNO-NCW is positive about the fact that in paragraph 22 regimes that grant a tax deduction for invested equity are appropriately excluded from the scope of the proposed hybrids rules. In substance the Brazilian interest on net equity (IONE) is very similar to other countries' regimes that grant a tax deduction for invested equity, but it differs in the sense that the IONE regime results in an actual payment. This leads to some uncertainty as to whether the IONE would be caught by the proposed rules. It would be helpful therefore to make specific reference in paragraph 22 of the Discussion Draft to clarify that such is not within the scope of the proposed rules, providing further clarity to individual countries when defining the scope of their hybrid instrument rules.

5. VNO-NCW is pleased that in paragraph 27 design principles for the hybrid mismatch rules are set out. However, we feel it would be best if there would be a common set of overarching design principles that cover all Action Points and to which all recommendations that follow from the Action Points can be measured.

6. We support the OECD's work to neutralise the effects of hybrid mismatch arrangements that are designed, and which sole purpose it is to erode the tax base of one or more jurisdictions. To strengthen the trust in the international tax system it is important that both double taxation, and double non-taxation are prevented. For this, it is essential to make a clear distinction between intended and unintended non-taxation. In the Action Plan on Base Erosion and Profit Shifting, it is stated that "no or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it." The distinction between intended and unintended non-taxation provides meaning to the difference between tax efficiency and aggressive tax planning from a business point of view, and regular tax policies and harmful tax practices from a government point of view. Businesses should be allowed to respond to legislative tax initiatives without being reproached for aggressive tax planning and governments need to agree on acceptable forms of tax competition.

7. The Discussion Draft seems to suggest that hybrid results (especially in the related party context) are simple to ascertain and quantify. However, often the treatment in another country is unclear (even in the related party context) as to accounting, partial coverage, etc. We believe that the Discussion Draft should be more realistic about this complexity and the administrative burden caused by this.

8. This administrative burden should not be seen separately from the significant administrative work that the other Action Points will cause. We believe that with reference to measures included in the combined published Discussion Drafts already business will be faced with enormous complex compliance and administrative burdens in combination with great uncertainty.

9. The Discussion Draft attempts to be all-encompassing in combatting hybrid mismatch arrangements. Although commendable, this level of ambition and comprehensiveness threatens to result in measures that are very complex in nature and very hard to apply in practice by both businesses and tax authorities. This could make countries reluctant to adopt them, and/or result in situations where measures hit situations that are not intended. In short, the proposed ambitious approach will ultimately cause measures to not be in line with the design principles of paragraph 27 and/or to not be targeted and proportional.

10. It would therefore be far better to narrow the scope of the proposed measures to only target specific problematic hybrid mismatch arrangements, increasing the chances that the measures will be collectively adopted by all jurisdictions and thus be far more effective.

11. By proposing both a primary and secondary rule (and in relation to certain categories of transactions even a further recommendation to domestic law) which differ amongst the different categories of transactions, there is a significant risk that some countries will opt to not implement the proposed measures, but instead rely on other countries to counter the effects of problematic hybrid mismatch arrangements. This is not conducive of achieving a consistent global approach in dealing with these types of arrangements.

12. We would strongly advocate that the OECD in their recommendations make a single choice in how to deal with specific problematic hybrid mismatch arrangements, instead of proposing both a primary and secondary rule (or even a further rule) which add to the complexity and administrative burden associated with the proposed rules. In doing so, the OECD should make sure that other initiatives to deal with problematic hybrid mismatch arrangements, such as the EU proposal to amend the Parent-Subsidiary Directive, are aligned with the OECD approach. In any event, it has to be avoided that diverse, conflicting initiatives end up creating situations of double taxation.

13. The main reason for issuing any AT1 or other regulatory capital is to manage solvency and/or ratings. The issuance of such capital has to be approved by the issuing bank's supervisory authority. Furthermore, most of these instruments will be publicly issued so that the tax treatment of the holder of the instrument is unknown. In addition, investors will usually seek for clearance that there are no tax issues that could lead the borrower to call the loan prematurely, for example the risk that interest payments will be non-deductible. Therefore, it is more than unlikely that these loans would be issued solely for tax planning purposes. Hybrid regulatory capital should therefore be fully carved out from the hybrid mismatch rules otherwise major practical issues in determining tax deductibility at the issuer side would ensue.

14. We believe that there has to be more attention for the interactions between the Action Point in this Discussion Draft and the other Action Points, specifically in relation to Action Point 3 on strengthening CFC rules and Action Point 4 on limiting base erosion via interest deductions and other financial payments. Not least, because the results of the latter Action Points are expected in 2015 while Action Point 2 should deliver results in 2014.

15. Additionally, the proposed measures could be in conflict with EU law. This could mean that EU countries would not be able to adopt the proposed measures in their domestic legislation. Further analysis on the EU law aspects is therefore needed.

We hope you will take these comments into consideration in further developing recommendations regarding this Action Point. Of course, we are at your disposal to discuss these comments with you should you find this useful. Also, we look forward to the public consultation on this important issue.

Sincerely Yours,

Jeroen Lammers
Manager Fiscal Affairs

SVENSKT NÄRINGSLIV
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# Confederation of Swedish Enterprise – Comments on the OECD Public Discussion Draft entitled "BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements" 19 March 2014 – 2 May 2014

**Submitted by email: aggressivetaxplanning@oecd.org and taxtreaties@oecd.org**

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled "BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements" 19 March 2014 – 2 May 2014 (hereinafter referred to as the Draft).

ACTION 2 – **Neutralise the effects of hybrid mismatch arrangements**

> *"Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) 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); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping."*

The Confederation of Swedish Enterprise supports the OECDs work to address mismatches with respect to hybrid instruments and hybrid entities. Unintended non-taxation should be addressed in order to ensure a level playing field and a coherent tax system. The aim should be to address such mismatches with a minimum impact on financial markets and genuine business activities. From a business perspective and as an overriding principle, group structures and financial flows should not be steered by tax rules.

It is important to underline that hybrid mismatches is a symptom of classification and characterisation differences in different jurisdictions tax laws. While we support the work on eliminating such mismatches, it should be acknowledged that financial instruments and entities that may cause hybrid mismatches are, per se, not the problem. Such instruments and entities may in fact be very important for businesses in their business activities. Thus, we support that it is the mismatch effect and not the instruments or entities themselves that should be addressed.

It is of utmost importance to make a clear distinction between intended and un-intended non-taxation. In the Action Plan on Base Erosion and Profit Shifting, it is stated that “no or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.” The distinction between intended and unintended non-taxation provides meaning to differences between tax efficiency and aggressive tax planning from a business point of view, and normal tax policy and harmful tax practices from a government point of view. Businesses should be allowed to respond to legislative tax initiatives without being accused of aggressive tax planning and governments need to agree on acceptable forms of tax competition.

If one country openly refrains from taxation (intended non-taxation), another country should not automatically be allowed to undo this effect by taxing the income. If that were to happen, the efficiency of the first country tax policy objectives would be undermined and tax revenues would de facto unduly be exported to another country. It is important to address each situation, and distinguishing this situation from a situation in which unintended non-taxation arises due to double deductions or lack of inclusion despite legal intent.

Consequently, any recommendation to address hybrid mismatches should be limited to target only *unintended* non-taxation. It should be recognised that the fact that a payment is not subject to tax in either jurisdiction in case of a cross border transaction does not by itself mean that it is a matter of base erosion or profit shifting.

The Draft seems to indicate that the risk for tax arbitrage, as a result of hybrid mismatches, is greater in transactions between related entities than is the case between unrelated entities. Considering the fact that a significant portion of cross border transactions is between related entities it is important that the provisions are designed in such a way that genuine businesses do not need to assess whether there is a risk for hybrid mismatch in each and every cross border arrangement. If that were to be the case, it would increase the threshold for cross boarder arrangements and definitely have a very negative impact on trade and investments. Such a scenario is certainly not the purpose of the BEPS project.

The main issue with respect to hybrid mismatch is tax arbitrage as a result of arrangements that involves two or more jurisdictions and where either duplicate


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deductions are granted with respect to the same payment, or where a deduction is granted without the inclusion of the same payment in the ordinary income of a party of the arrangement. It is however not recognized in the report that the mirror of this problem is the risk for double taxation. As a result of different classifications and characterizations, an arrangement may result in two jurisdictions denying deductions or requiring inclusion of the same payment in the ordinary income of more than one entity. Often, such cases of double taxation may be neutralized by tax treaties. This is however not always the case. Furthermore, in light of the BEPS project, businesses are concerned that the risk for double taxation may increase significantly. At the same time, access to treaty benefits is likely to be limited as a result of the current work on Action 6 addressing treaty abuse.

Because of the potential for double taxation as a result of the proposed hybrid rules, we recommend that the enactment of the rules be clearly linked to the adoption of strong and expeditious dispute-resolution processes, including Mutual Agreement Procedures and binding arbitration for cross-border disputes.

Furthermore, we are very concerned about the complexity of the recommendations in the Draft. Under the recommendations for domestic laws, taxpayer's deduction or inclusion is linked to whether deduction or inclusion is granted or required in another jurisdiction. We are concerned that such an approach would impose a significant compliance burden on taxpayers, particularly if information is to be obtained from non-related entities and/or entities not under control. Taxpayers would be required to learn not only how the arrangement is to be treated in the tax law of their own jurisdiction, they would also have to understand the tax laws of the jurisdiction of their counterparties (and in some cases even more than one other jurisdiction). The tax treatment in each jurisdiction may by itself be unclear and difficult to predict. This approach is very complex and is in contrast with the design principles in para 27 in the Draft (in particular (h) "be workable for taxpayers and keep compliance burden at a minimum"). Consequently, we believe that the recommendations should be designed in such a way that the complexity is kept at a minimum.

The Draft recommends a two-step approach which may differ per category of hybrid mismatch. The recommended primary rule is supplemented by a secondary rule in case a primary rule is not adopted. In addition, further recommendations in relations to certain transactions are made. We worry that the two-step approach may, as a result of two or more jurisdictions denying deduction or requiring inclusion of the same payment in the taxpayer's ordinary income, increase the risk of double taxation and add to the complexity.

We also note that the recommendations in general are not limited to abusive circumstances. This is in our opinion another reason for designing the rules in a matter that would keep the impact in genuine business activities at a minimum.

In this respect we also believe that the recommendations on hybrid mismatches should be coordinated with the other actions items on CFC, interest deductibility and harmful tax practices. That way, interaction between the overall recommendations is ensured, whilst at the same time the impact thereof across jurisdictions is balanced.

With respect to the proposal to amend Article 1 of the OECD Model Convention, the Confederation of Swedish Enterprise understands that there may be some cause for concern with respect to hybrid entities. We do however believe that this is best addressed through recommendations for more uniform domestic tax rules rather than amendments to the OECD Model Convention. The initial and prime objective


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with tax treaties is and should continue to be to facilitate cross-border trade through the allocation of taxing right between countries and to provide for mechanisms to eliminate double-taxation. Consequently, tax treaties should not be overwhelmed with anti-abuse provisions that may undermine that purpose.

On behalf of the Confederation of Swedish Enterprise

April 29, 2014

Krister Andersson
Head of the Tax Policy Department


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*International Co-operation and Tax Administration Division, OECD/CTPA*

2 May 2014

**Comments on the BEPS Action 2 Draft of 19 March 2014 (hybrid mismatch – domestic laws)**

By Gaetano Pizzitola, Crowe Horwath Italy - Partner in charge of Cross-Border Tax Services[1]

Dear Mr. Pross,

We are pleased for the opportunity to submit our brief comments on the subject matter (the "Draft").

The Draft contains a thorough analysis on a wide inventory of instruments and structures providing for double tax benefits in two Countries because of mismatches on their tax treatment based on the legislation of the relevant Countries.

The Draft notes at paragraph 22 that similar results to hybrids may arise from legislative measures as introduced by some Countries, such as any notional interest deduction on equity as applicable in Countries such as Belgium, Brazil and Italy. Paragraph 22 justifies the tax savings arising in cross-border scenarios from those mechanisms by arguing that they are *economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated by Action 2.*

Paragraph 22 seems to draw a line between good and bad hybridisation depending on whether double benefits follow from intended or unintended effects of the tax policy of each single Country.

Indeed, similar tax benefits such as the ones challenged under the BEPS doctrine may arise in a cross-border scenario from special regimes such as interest box regimes or even by significant tax rates differentials. Let alone CFC rules, the tax savings realized by an Irish Finco of a Spanish parent company funded with equity lending to a French company are not very much different from the tax savings that may arise with a hybrid instrument or vehicle involving companies of two Countries with

[1] Comments are sent as partner in charge of Cross-border Tax Services of *SASPI - Studio Associato Servizi Professionali Integrati*, Italian member firm of Crowe Horwath International providing tax and legal services in Italy, and on behalf of the latter Italian firm.

an effective tax rate around 20%. In both cases, hybrid or not, the same tax savings may *de facto* be achieved.

The Draft also restricts its scope under paragraph 26 by excluding from the line of fire cases with double deductions *to the extent they are offset against income that is taxable under the laws of both jurisdictions or to the extent the DD outcome simply results in shifting the net income of the taxpayer from one taxable period to another*.

The Draft recommends implementation of linking rules to address hybrid mismatches that would apply a primary principle and a subordinated one depending on the tax treatment in the payer or investor country on a case-by-case basis depending on the nature of the hybrid mismatch, whether an instrument, an entity or of other nature.

The BEPS pursuit is inspired by the fairest objectives of ensuring cross-border justice, which however will depend upon the implementation of those fair principles by each Country on a stand alone basis.

BEPS has been sponsored by the G20, which includes all the EU Countries, either participating on a Country basis such as France, Germany, Italy, the UK or as EU as a whole. The OECD includes most of the EU Countries, currently 21 Countries out of the 28 members.

The influence of EU law on hybrid instruments has thoroughly been analysed recently by Jakob Bundgaard in an essay published on European Taxation.[2]

Author Bundgaard concludes his essay by raising concerns that measures such as the ones proposed under the Draft may not be justified under the Primary EU Law by suggesting that the impact of the European Treaty be *fully clarified before all Member States fall completely in love with such provisions in the global battle against tax arbitrage.*[3]

We fully endorse such a recommendation by noting that the Draft, by being OECD-based, does not seem to analyse the impact of EU and any further supranational legislation (other than OECD Model treaty but only with respect to its application under the separate Treaty Issues Draft) on the primary response and defensive rule approaches as recommended in the Draft itself.

Although the Draft has a broader scope than any EU membership, it is quite clear that the Draft has been inspired by tax planning structures of US multinationals doing business in the EU.

We believe that not all the EU Countries have the same tax agenda when tackling hybrids because of different tax policies, objectives and constraints. Some EU Countries have benefited from EU tax principles and primary laws by attracting non-EU investments much more than other Countries by designing tax competitive legislation better than others.

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[2] *Hybrid Financial Instruments and Primary EU Law*, European Taxation, November (Part 1) and December (Part 2) 2013.
[3] Budgaard, *supra*, European Taxation, December 2013, p. 594.

Tackling hybrids without designing a tax competitive framework legislation would continue to have winners and losers within the EU, the latter being all EU Members unable to reduce significantly their business tax burden up to a competitive level with all Countries that are benefiting from very low statutory rates or other tax mechanisms such as box tax rules, deemed deductions and generous ruling practices.[4]

It is a political paradox that BEPS is tackling aggressive tax structures by MNEs that would hardly be conceivable if the EU Countries members of all communities inspiring such an action (OECD and G20) had agreed a common income tax policy as they had been managing with respect to custom duties, capital tax and VAT.

Absent common principles, in our view,high tax Countries better think twice before *falling completely in love with such provisions in the global battle against tax arbitrage*, as acutely stated by Jakob Bundgaard before the Draft was released.

Thank you for the opportunity to provide our view on this topic.

*SASPI – Studio Associato Servizi Professionali Integrati*
Italian member firm of Crowe Horwath International
Tax and Legal Services

Gaetano Pizzitola

Partner in charge of Cross-Border Tax Services

[4] For a good example of Countries tackling BEPS while looking after tax competitiveness, see the speech by the UK Exchequer Secretary to the Treasury David Gauke to the Lord Mayor's Taxation Forum on the 30th of April 2014 at https://www.gov.uk/government/speeches/david-gaukes-speech-to-the-lord-mayors-taxation-forum.

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**Via email**
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Lausanne, 2 May 2014

**BEPS Action Item 2: Neutralize the effect of hybrid mismatch arrangements (Treaty Issues) – Comments on proposed provision and commentaries aimed at ensuring that transparent entities are not used to obtain the benefits of treaties unduly**

Dear Marlies,

Please kindly find hereafter my comments relating to item 2 (ensuring that transparent entities are not used to obtain the benefits of treaties unduly) of the above-mentioned discussion draft.

## I. Clarification versus extension of the principles of the partnership report

The proposed amendment to the OECD MC is designed to address so-called "conflicts of attribution" involving entities or arrangements that are wholly or partly fiscally transparent. As is well known, these conflicts arise where, as a result of diverging domestic tax laws, the Contracting States allocate the same item of income to different taxpayers. In essence, problematic is here the fact that the distributive rules of the OECD MC, by using terms such as "paid to" and "derived by", require a connection between the income and a given taxpayer but do not define this connection[1].

Further to the 1999 OECD Partnership Report, the 2000 OECD Commentary already contains recommendations dealing with this problem. According to these recommendations, the State of source should, for the purpose of applying the distributive rules and defining terms such as "paid to" or "derived by", rely on the attribution rules of the State of residence[2]. Conversely, according to the report, the state of residence should provide double taxation relief for the

[1] See thereupon and recently, Robert Danon, Qualification of Taxable Entities and Treaty Protection, Bulletin for International Taxation 2014

[2] OECD Commentary para. 6.3 ad Art. 1 OECD MC, 2000 addition in accordance with the OECD Partnership report, p.54 : *"(…) the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident*

residual tax levied by the State of source even if the latter levies it on a different taxpayer under its internal law. Yet, according to the report and the OECD commentary, the foregoing general recommendation does not prevent the State of source from taxing its own residents[3].

While some States have accepted the foregoing recommendations (and sometimes even extend these recommendations beyond cases involving partnerships), other jurisdictions, by contrast, are not prepared to apply these recommendations, absent a specific tax treaty provision. Therefore, the inclusion of an express provision into the OECD MC makes sense. Subject to certain changes, which are discussed below, the provision proposed by the discussion draft is clearly inspired from art. 1(6) of the 2006 US Model Tax Convention. The US MC is a natural starting point in this area as it is fair to say that the recommendations of the partnership report were themselves inspired from US international tax policy, in particular art. 4(1)(d) of the 1996 US MC, which contained a similar language.

This being said, in our opinion, the introduction of the provision proposed by the discussion draft into the OECD MC should be interpreted as only aiming to **clarify and confirm** the principles embodied in the OECD partnership report. This interpretation ensures consistency with the 2000 update of the OECD Commentary, which was meant to apply absent a treaty provision, an interpretation, which is still shared by some States. Further, at the time, the OECD already recognized that the principles of the report were not only applicable to partnerships but could also come into play with respect to other entities such as trusts.

Under the foregoing interpretation, therefore, the introduction of a specific provision into the OECD MC dealing specifically with conflict of attribution involving hybrid entities or arrangements, should not preclude States from applying the principles of the partnership report to other conflicts of attribution not involving hybrid entities. From this perspective, para. 26.5 which states that the proposed provision "*not only serves to confirm the conclusions of the Partnership Report but also extends the application of these conclusions to situations that were not directly covered by the Report »* is slightly misleading. Indeed, this language could suggest that the principles of the report may not be applied to other areas absent a specific tax treaty provision. In light of the foregoing, we would thus redraft proposed para. 26.5 as follows: "*(…) the paragraph only serves to confirm the conclusions of the Partnership Report as well as the application of these conclusions to situations involving entities or arrangements, which were not directly covered by the Report. Paragraph 2 does however not exclude the application of the*

3 OECD Commentary para. 6.1 ad Art. 1 OECD MC. See also OECD 1999 partnership report example 16, p. 46 et seq.

*conclusions of the partnership report to other forms of conflicts of allocation of income not covered by this provision.*

## II. Comments on the language of the provision proposed and its application

In substance, the provision proposed by the discussion draft is very similar to art. 1(6) of the US MC. Yet, while art. 1(6) US MC refers to: "*An item of income, profit or gain derived through an entity that is fiscally transparent",* the proposed amendment to art. 1 (para. 2) refers by contrast to an: "*an entity or arrangement that is treated as wholly or partly fiscally transparent".*

Presumably, the foregoing difference in drafting is mainly intended to clarify that the eligibility to treaty benefits, respectively the application of the distributive rules, should be considered separately for each item of income by looking as to whether the latter is attributable to a resident. This approach, which corresponds to the principles of the partnership report and is correct, is particularly relevant where, for example, the attribution of the income is split between the entity and its participants. As correctly mentioned by proposed para. 26.11 and 26.12, this frequently holds true in a trust relationship where income currently distributed is attributed to a resident beneficiary while accumulated income is attributed to the trustee or to the trust. In these instances, treaty entitlement would need to be examined separately at the level of the beneficiary and trust (trustee) as regards the respective share of income attributable to them. As also illustrated by para. 26.7, this thus entails only partial treaty entitlement where a recipient of part of the income is not resident in the other contracting State.

Para. 26.13 could also address explicitly the **relation between income attribution** under the proposed rule and **the other personal circumstances**, which may need to be satisfied by the recipient of the income, for example those provided by art. 10(2)(a) OECD MC. Under this provision, the lower rate of 5% applies provided the beneficial owner resident in the other contracting State is a company (other than a partnership) which holds directly at least 25% of the capital of the company paying the dividends. The interaction between the proposed rule and art. 10(2)(a) OECD MC is particularly relevant in the field of partnerships. Two main situations may in essence be contemplated.

The first situation, the most obvious one, concerns the case in which a partnership receives dividends from the State of source and is treated as a separate taxpayer in the State of residence but as fiscally transparent by the State of source. In this situation, also contemplated by example 8 of the OECD partnership report, the State of source should consider that dividends

are derived by the partnership and grant treaty benefits accordingly. As mentioned by the partnership report, the lower rate of 5% would however not apply if the applicable tax treaty contains the "other than a partnership" language provided by art. 10(2)(a) OECD MC.

In the second situation, the reverse case, the entity is on the contrary regarded as fiscally transparent by the State of residence and as non-transparent by the State of source. Suppose further that the entity is held by individuals who, for the sake of simplicity, are all residing in the State of residence. In such case, these individuals would be regarded as deriving the income under the proposed provision and under the partnership report. Therefore, whether the conditions of article 10(2)(a) OECD MC are satisfied should logically be examined at the level of these persons so that the lower rate should not apply in such instance. A teleological interpretation of art. 10(2)(a) OECD MC by reference to its purpose (reduction of economic double taxation) leads to the same result. Some national courts, however, do not necessarily share this interpretation (see for example recently German Bundesfinanzhof Judgment of 26 June 2013, case N 48/12 in: International Tax Law Reports 2014, p. 428 seq. which concerned an S-corporation which had elected for transparency in the US; see also earlier and in the same vein German Bundesfinanzhof Judgment of 20 August 2008, case N 39/07).

Conversely, in the foregoing case, the lower rate provided by art. 10(2)(a) OECD MC should apply if the partner is not an individual but a company and the 25% threshold is satisfied. Further, the fact that the partner here directly derives the income should also be taken into consideration for the purpose of construing the "direct ownership" requirement. Accordingly, the corporate partner should be regarded as owning the distributing subsidiary directly even if a partnership is interposed between the two companies but that, under the laws of the state of residence of the partner, this partnership is treated as fiscally transparent.

In our opinion, the foregoing issues should be clarified by the proposed provision or commentaries to ensure complete consistency of the principles of the partnership in the area of treaty entitlement.

## III. Relation of proposed provision with the beneficial ownership requirement

Para. 26.14 very appropriately distinguishes the issue of income attribution from the beneficial ownership requirement. Accordingly, as illustrated by the example in this paragraph, the fact that a person derives an item of income as a resident does not necessarily mean that this person is the beneficial owner thereof. In particular, the State of source should not be expected

to grant treaty benefits where the person deriving the income as a resident acts a mere agent, nominee or conduit for a non-resident.

This being said, in some cases, the State of residence may fictitiously attribute an item of income to a person (pursuant for example to a substance/anti-avoidance attribution rule) without this person having any form of enjoyment or control over such item. This particularly holds true in the field of trust relationship as regards the attribution of income to the settlor pursuant to provisions such as "grantor trust rules". Where such a deemed attribution rule is applied by the residence state, income may well be regarded as paid to the recipient within the meaning of the distributive rules, but, strictly speaking, this person may not be regarded as the beneficial owner of the income. At the same time, however, the item is here effectively taxed in the hands of the recipient in the State of residence. In our view, it would be appropriate for the commentary to refer to this problem and possibly to suggest that, where, under a deemed attribution rule, the recipient is taxed on an item of income arising in the source state, the contracting states may agree to deem this person to be the beneficial owner, even if, in this particular instance, this person does not hold any ownership attribute over the income received.

## IV. Right of a State to tax its own residents

Para. 26.16 mirrors the principle of the saving clause proposed by the discussion draft on action item N 6 as well as the conclusions taken in examples 16 and 17 of the partnership report and reiterated by para. 6.1 of the commentary to art. 1. Where however a State taxes its own resident, the obligation to provide relief under the terms of art. 23 A and B remains applicable.

Therefore, as illustrated by example 16 of the partnership report, if for example a partnership regarded as a taxable entity and resident in State P derives royalty income from State R, a jurisdiction in which one of its partners also resides, this latter country could rely on its own attribution rules to directly assess this partner as a resident. Yet, in such case, the obligation for State R to provide double taxation relief under art. 23 A and B may remain applicable. Indeed, if State R attributes the partnership income to a resident partner, article 7 OECD MC applies. Accordingly, State R may, depending on the circumstances, consider that this partner maintains a permanent establishment in State P at the place of organization of the partnership. Following this line of reasoning, State R should therefore provide double taxation relief pursuant to article 23 A or B OECD MC as regards the partnership income attributed to the fixed place of business[4]. Moreover, as discussed above, State R should provide double taxation relief to its

[4] OECD 1999 partnership report, para. 129

resident partner through the credit method even if, in State P taxes are levied in the hands of the partnership.

However, this outcome is specific to partnerships but may well not hold true where a different type of hybrid entity is at stake. Consider for example a similar fact pattern involving a trust. Assume that T is a trust established under the laws of State R. The settlor of T, S, is a State R resident individual. Under the settlement, S has retained certain powers so that under the attribution rules of State R, all income of the trust is assigned to S. The beneficiary of T, B, is entitled to receive all periodical income derived by T. B is a resident of State S and under the laws of this State, on the contrary, all income of the trust is attributed to B. Assume finally that T derives royalty income from State S[5].

Following the foregoing principle, article 12 of the S-R tax treaty would not apply and would not prevent State S from taxing its resident individual taxpayer. Rather, from the perspective of State S, this internal situation would be falling under article 21 OECD MC. State R, by contrast, would be taxing the same income in the hands of the settlor of T. However, unlike in the case contemplated the OECD partnership report, B does of course not maintain a permanent establishment in State R so that it is impossible to argue that State B should provide double taxation relief under article 23 of the tax treaty. In this particular scenario, therefore, the approach taken leads to full double taxation.

Since the foregoing outcome typically comes into play with respect to trusts to which the provision proposed by the discussion draft is intended to also apply, the proposed commentaries could clarify that, in these instances, the contracting States may wish to agree that one State would provide relief for the taxes levied by the other (for example the State of residence of the settlor for the taxes levied by the other State in the hands of the beneficiary). Such understanding is for example provided in the exchange of notes to the US-UK tax treaty which expressly provides for double taxation relief in such situation and in a specific trust situation: *"In the case where the same item of income, profit or gain derived through a trust is treated by each Contracting State as derived by different persons resident in either State, and a) the person taxed by one State is the settlor or grantor of a trust; and b) the person taxed by the other State is a beneficiary of that trust, the tax paid or accrued by the beneficiary shall be treated as if it were paid or accrued by the settlor or*

[5] See Robert Danon, Switzerland's direct and international taxation of private express trusts, Zurich (Schulthess), 2003, p. 305 et seq.

*grantor for the purposes of determining the relief from double taxation to be allowed by the State of which that settlor or grantor is a resident (or, in the case of the United States, a citizen)"*[6].

## V. Alternative approach

Finally, while the proposed provision is limited to conflicts of attribution involving hybrid entities or arrangements, let us observe that a more comprehensive approach to solve conflicts of attribution in general would also be technically conceivable. For this purpose, the proposed provision could simply be turned into a general one with the following alternative language: *"For the purpose of the purposes of this Convention and unless the context otherwise requires, an item of income, profit or gain shall be considered as directly derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident"*[7]. In order to ensure perfect consistency with the distributive rules, the expression "derived by" could then be included in all distributive rules (instead of "paid to", "of" etc.). Technically, this alternative provision would really consist in a definition of a term contained in the distributive rules. Therefore, from a systematic standpoint, it would be more logical to include it into article 3 OECD MC. This rule would of course still not prevent the source State from taxing its own residents in accordance with the saving clause. Further, under this rule, treaty benefits to be granted by the State of source would remain subject to the other usual conditions. Accordingly, treaty benefits could be denied where the person "deriving" the income is not the beneficial owner or where a main purpose rule or LOB (contemplated by the discussion draft on Action Item 6) applies. Finally, it must be recognized that generally requiring the State of source to follow the attribution rules of the State of residence may raise concerns as regards the possibility of this latter State to expand its taxing right by adopting new attribution rules. States concerned with this problem could however simply reserve not to apply the proposed rule in cases where a conflict of attribution results from a modification to the internal law of the State of residence subsequent to the conclusion of the Convention[8].

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6 Exchange of notes to the new US-UK DTC 2001 ad Art. 24 (Relief from double taxation)

7 The proposed approach is similar but still different from the one suggested by Wheeler J, The Missing Keystone of Income Tax Treaties, Amsterdam 2012 (IBFD doctoral series), see in particular p. 165 et seq. which is even more comprehensive and innovative. This author suggests indeed a fundamental change to the structure of the OECD MC by shifting treaty entitlement from persons to income through inter alia an amendment to art. 1. Our approach is by contrast less ambitious and simply amounts to propose a uniform definition of « derived by » for the purpose of the distributive rules and without affecting art. 1, which would thus continue to place the emphasis on persons rather than income.

8 This is the approach taken by Switzerland in its observation to art. 23 (para. 81) in the context of conflicts of qualification and with respect to a subsequent amendment of its domestic law by the State of source.

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Trusting to have been of assistance, I remain with pleasure at your disposal in this context.

Yours sincerely,

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2 May 2014
Our ref: WJID/LS

Dear Sirs

## Discussion Draft on BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements- Recommendations for Domestic Laws

We are glad to comment on the non-consensus Discussion Draft in respect of Recommendations for Domestic Laws released on 19th March 2014 (the 'Discussion Draft'). Our comments are made from the perspective of the UK

Hybrid mismatch arrangements are a product of mismatches between independent national tax systems. Many of these mismatches arise as a result of commercial arrangements. We do acknowledge, though, that some hybrid transactions can lead to base erosion and double non-taxation of the type that the G20 and OECD have identified as needing action. However, as the OECD and others have also noted, the Action on Hybrids is closely linked with other actions, principally Action 4 (interest deductions) but also Action 5 (Harmful tax practices). We would respectfully suggest that Coherence requires broader coordination of policy rather than moving forward with a single action. The Discussion Draft notes, for example, that it does not impact country tax regimes which allow a notional interest deduction, which offer similar economic results to some hybrids.

The objectives and design principles of the recommendations in the Discussion Draft are generally clear – although we think that the Discussion Draft under-estimates the complexity of taking forward its recommendations. Although the Action Plan establishes the principle that a country should not be forced to rely on the domestic laws of other jurisdictions, in practice there are likely to be many cases where significant complexity arises in establishing the tax treatment in another country. In addition, the level of complexity in designing legislation capable of effective implementation in the domestic law of a large number of diverse territories should not be underestimated. The widespread and timely implementation of consistent rules will be the key to effectively tackling the base erosion and profit shifting associated with hybrid mismatch arrangements.

In our view, it is essential that the recommendations made by the OECD in respect of hybrid mismatch arrangements should take a targeted approach to base erosion. This entails adoption of the so-called "bottom up" approach which focuses on related parties and structured arrangements in

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relation to related parties. A definitions of related parties in line with the consolidation requirements of generally accepted accounting standards (i.e. greater than 50% ownership) would be more appropriate than the current widely drawn definition. Extending the approach more widely would carry the risk of disruption to financial markets; would be much more complex to operate and would almost certainly bring non-abusive financing arrangements within their ambit.

In terms of counter-action, our view is that the primary rule should be to tax income and that the secondary rule should be to disallow deductions. Economically the appropriate answer is to permit a company a tax deduction for its finance costs (subject where appropriate to transfer pricing and other rules). The country of the investor will be better placed to investigate hybridity and impose taxation.

There is concern that the hybrid mismatch rules will have a disproportionately negative effect on the regulated financial services sector when using hybrid instruments that have been entered into as a result of regulator direction, rather than being chosen by the business. The case for specific rules designed to reduce the impact of the hybrid mismatch proposals on banks' and insurers' issuance of regulatory capital should be considered in the light of evidence about the wider commercial constraints arising from the regulatory environment.

The changes implied by this Action have the ability to cause significant disruption for business and for tax authorities. In our view, consideration should be given to grand-fathering existing arrangements for a period of years as well as introducing effective transitional relief which will assist (or at least not impede) the adoption by business of new arrangements in accordance with the post-BEPS accord.

We set out in Appendix 1 our detailed comments on each section of the Discussion Draft, including our response to the specific questions highlighted.

If you wish to discuss any of the points raised in this letter, please do not hesitate to contact either me (bdodwell@deloitte.co.uk), or Joanne Pleasant (jmpleasant@deloitte.co.uk)].

Yours faithfully

**W J I Dodwell**
**Deloitte LLP**

**Appendix 1**

**1. Design of Hybrid Mismatch Rules**

***1. Are the objectives and design principles of the hybrid mismatch arrangements clear?***

Part II sets out a comprehensive and generally well thought through overview of the design of the proposed hybrid mismatch rules. It clearly sets out the key mismatch arrangements which the rules seek to address and the categories of arrangements in place to achieve these mismatches, illustrated through a range of examples.

Some intermediary jurisdictions such as Luxembourg have pursued a strategy designed to offer the flexibility to businesses to achieve the level of hybridity desired of an entity/instrument. Unless these territories change their approach it is likely that some hybrid mismatch strategies will continue to be utilised despite the implementation of the proposed rules by other territories. The approach to tax havens is outside the scope of this action, however it will be difficult to fully deal with every hybrid category without consideration of this issue.

*Implementation*

The way in which the recommendations are implemented will be a key component in determining their success. The complexity of implementing these rules on an international basis should not be underestimated.

We agree with the comments that rules that are not comprehensive will create further unintended tax planning opportunities. To the extent that all jurisdictions follow the recommendations in a consistent manner and within a reasonable timeframe, the rules will be comprehensive and effective. The adoption of consistent definitions is essential if the linking rules are to work as intended and further definitions which can be widely accepted will be needed. However, variations or delays in implementation may result in contrived, or even increased, hybrid treatment. The Discussion Draft anticipates widespread and consistent adoption, but consideration should be given to the practical issues that may arise if this is not the case.

(i) Timing of implementation by individual countries

The Discussion Draft confirms that “the Action Plan does not contemplate a country being forced to rely on the domestic laws of other jurisdictions in order to protect their own tax base” and, in principle, the linking rules should achieve this. However, the success of the rules relies on wide scale implementation. If this is not achieved, then early adopters may effectively reduce their competitiveness and lose tax revenues if businesses choose to restructure their operations to jurisdictions where the recommendations have not been implemented.

Consideration should be given to the development of a commitment by jurisdictions to adopt these recommendations simultaneously or at least within a narrow timeframe.

As a result of the way the rules work, a staggered introduction may mean that businesses are required to tax a transaction in a different way in successive periods. For instance, in respect of a hybrid entity payment, a deduction may be denied in the subsidiary jurisdiction under the defensive rule if the investor jurisdiction does not initially adopt the rules. If the investor jurisdiction subsequently adopts the rules, a

deduction would be denied in that jurisdiction in subsequent periods. The implementation of any new rules introduces additional costs and administrative burden in the years of adoption- for both business and tax authorities. These costs will increase where adoption is not synchronised. This may also result in variations in the level of tax paid in each territory between periods; it is important for both tax authorities and businesses to have certainty over the level of taxes paid in each territory.

Sufficient time should be given to businesses to restructure their operations and therefore the rules should not be effective before 2017 to give tax authorities and tax payers time to consider detailed implementation points.

*(ii) Grandfathering provisions for business*

The proposed changes are expected to increase the cost of financing and business will need time to adapt to these changes. For some businesses, particularly those operating with low margins, an unexpected increase in financing charges may mean that profitability is threatened such that the business is no longer viable. More generally, a key investor relations issue is the level of confidence held in a consistent effective tax rate as this allows investors to accurately model predicted results. This issue can be dealt with provided business has enough time to respond to changes and inform the market in advance rather than surprising the market by reporting unexpected variations in effective tax rates.

A grandfathering clause would allow the current arrangements to remain effective until the earlier of the end of the loan term or termination of the loan by either party. A safeguard could be introduced to impose a maximum period of years. This would allow business time to restructure their operations in line with the new proposed rules. We suggest the OECD should recommend that countries should not impose domestic anti-avoidance provisions in relation to restructuring out of existing arrangements.

*Scope*

If implemented widely and consistently, the proposed rules should reduce the number of hybrid arrangements in place that achieve profit shifting and base erosion outcomes. However, without addressing issues in respect of certain intermediary jurisdictions which facilitate hybrid arrangements, it is unlikely that the rules will be successful in eliminating all of the target arrangements. We note that some of these issues may be addressed under Action 5 in the context of Harmful Tax Practices.

The proposed scope of the rules varies depending on the type of hybrid considered. Specific comments on the advantages and disadvantages of a “top down” vs “bottom up” approach are considered in respect of hybrid financial instruments and transfer. Consideration of these approaches should be widened to cover a debate in respect of each of the different types of hybrid mismatches identified. An approach which focuses on related parties (and structured arrangements in relation to related parties), would ensure that the vast majority of mismatches designed to achieve profit shifting and base erosion outcomes would be brought within the scope.

Rules which go beyond this will create a disproportionate burden on businesses and almost certainly would bring non-abusive financing arrangements within their ambit.

*Double taxation*

We note the onus in the Discussion Draft on 'neutralising' hybrid mismatch rules. Depending on the detail of the implementation of the rules, there are a number of areas where the proposed rules could go beyond neutralisation and risk triggering double taxation. Please see our comments in respect of recourse for amendments below.

These issues should be dealt with as part of the OECD's work on the development of the detailed rules recommended in this Discussion Draft. Although the rules are intended to drive taxpayers towards less complicated and more transparent tax structuring, it is inevitable that hybrid mismatch arrangements will continue to arise in some cases. This is likely to be a particular issue in the short term if adequate time is not given for groups to restructure their operations. Sufficient resource will need to be available to allow businesses access to Mutual Agreement Procedures ("MAP") to minimise the level of double taxation paid.

*Commercial purpose test*

We note the comments in respect of the UK's domestic hybrid mismatch rules, which include a 'purpose' test. In our experience, the rules have been effective in counteracting their intended target. The proposed rules operate on a mechanical basis, which does not take account of the commerciality of arrangements or the alternatives available. In some cases, it may be that the tax charge arising under a hybrid mismatch arrangement is no different to that under the most likely alternative. A purposive rule should be considered alongside the mechanical test proposed as a mechanism to ensure that commercial arrangements are not brought within the proposed rules. This approach should reduce the amount of double taxation arising and therefore the pressure placed on MAP.

*Consistency*

The primary response in respect of hybrid financial instruments and transfers and hybrid entity payments with a D/NI result is for the payer jurisdiction to deny a deduction. However, this is the defensive rule in respect of reverse hybrids. The variations in approach changes the split of tax between different countries and a consistent approach should be followed as far as possible.

*European Union*

Consideration should be given to the implementation of the proposed rules in the context of organizations such as the European Union ("EU") which requires protection of freedom of capital and movement.

***2. If further clarification is required, then where is this required and how could it best be provided?***

*Provision of information*

The principle of the linking rule is designed to eliminate reliance on counterparty jurisdictions. The design principles include establishing rules which are workable for taxpayers and keep compliance costs to a minimum, and are easy for tax authorities to administer. For jurisdictions that operate on a self-assessment basis, the taxpayer will therefore be required to understand the tax treatment in each of the relevant territories i.e. in respect of a reverse hybrid, the payer would need to understand how the hybrid

mismatch rules have been implemented in the investor territory, and the intermediate jurisdiction in order to determine whether the deduction should be denied in its tax return.

In the case of wholly owned corporate groups this work would need to be undertaken by the relevant entity in each territory and may not result in additional costs. There may however be circumstances where the relevant entities are unaware of hybrid mismatches that are in place. Some jurisdictions have data protection rules that will limit the ability of group entities to share the required information. However, the widely drawn definition of a controlled group would also result in this information being required by minority shareholders which typically have no access or legal right to this information.

Further consideration should be given as to how the results will operate in jurisdictions which do not operate under a self-assessment regime.

Further guidance should be given on the detail of how the rules should be implemented. For instance, will businesses be required to provide proof of the application of a primary response to a tax authority in order to avoid that authority assessing a tax liability under a defensive rule? Different companies may have different accounting periods (particularly where they are not within a wholly owned group) and different jurisdictions will have different filing deadlines. It may not be clear at the time of filing of a tax return in the territory where the defensive rule could apply, whether the primary rule has been implemented in the relevant territory. This is another reason why the primary rule should be to require investor taxation.

*Recourse for amendments*

In addition, the final tax position in a territory may not be determined for many years. For example, a double deduction arises as a result of the use of a hybrid entity. The investor jurisdiction has not implemented the proposed hybrid rules and therefore will not deny the deduction under the primary rule. The subsidiary jurisdiction has implemented the rules and will therefore deny the deduction under the defensive rule.

After the close of the accounting period, the investor jurisdiction tax authority opens a tax audit which, after several years of correspondence and discussion, leads to an adjustment which reduces the level of deduction available in that territory. The rules are designed to neutralise hybrid mismatch arrangements, but in this type of scenario they would go beyond this. This difference arises as a result of the linking of the tax rules of the two different territories, but only in the context of hybrids.

In addition, although timing differences are not included in the scope of the proposed rules, it will be necessary to match the deduction and inclusions between different periods. Adjustments/reversals may be required if there is a change of facts or accounting treatment.

The Discussion Draft does not contemplate any differences between the amount that could be deducted in principle and the final amount actually deducted. Further clarification should be provided to determine how the amount of the deduction/income to be taxed should be calculated i.e. before or after the application of other relevant domestic rules that could alter the deductible/taxable amount.

There is no mechanism in the Discussion Draft for a compensating adjustment to be made to reduce the disallowance suffered in the subsidiary territory. Recommendations should be made for provisions to be included in domestic law to address this point, and this may necessitate the ability for taxpayers to amend tax returns after the normal window for adjustment has closed, or to make adjustments relating to previous periods through a current tax return. We note that this increases uncertainty for tax authorities

who may be required to make unexpected repayments depending on the outcome of a tax audit undertaken by another tax authority over which they have no knowledge or control.

**2. Hybrid Financial Instruments & Transfers**

*General Comments*

Convertible debt instruments are used for a variety of commercial purposes in a range of industries. For example, hedge funds often use convertible instruments to invest in distressed businesses. In addition, a number of publicly listed groups have issued convertible instruments to raise finance. As noted earlier, we do not believe that recommendations on hybrids should go beyond intragroup transactions. Going further than this would cause market disruption and put up the cost of raising commercial finance.

Action 2 referred to the consideration of "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)". Para 36 notes that this requirement is not reflected in the recommendations "in respect of D/NI arrangements arising under hybrid financial instruments, primarily due to concerns about workability and complexity of such a rule in that context." There are a number of areas of complexity in connection with the recommendations and this should not prevent taxation under CFC or other similar rules being taken into account when determining whether a mismatch has arisen.

***1 Is it clear what elements need to be present in order for the rules neutralising hybrid financial instruments or hybrid transfers to apply?***

***2 Is the outcome of the rules' operation clear?***

***3 Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?***

***4 This document sets out two possible approaches to drafting a scoping rule and summarises the possible advantages and disadvantages.***

- ***(a) Are the advantages and disadvantages accurately described and are there any other advantages and disadvantages of the two approaches?***
- ***(b) What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration?***

As noted, we consider that the disadvantages of the 'top-down' approach outweigh any possible advantage. A bottom up approach meets the objective of focusing on areas which raise the most significant concerns and is the more balanced approach. Third party arrangements are unlikely to be undertaken on anything other than a commercial arm's length basis. We believe that the definition of related party should be similar to accounting rules i.e. control of greater than 50%.

***5. This part includes a number of examples: -***
***(a)What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties position?***

***(b) In this context are there any examples or situations that are more problematic than others? If so please explain why problems arise and what constraints or restrictions the parties might face in obtaining relevant information on the treatment of the counterparty?***

***(c) To the extent that there are difficulties, do these apply equally to both the holder and issuer in the context of hybrid financial instruments?***

***(d)Are there any other situations or examples, not covered here that give rise to difficulties? In particular are there any specific problems for regulated businesses (see also Q. 8 below)?***

Under the proposed rules, bond holders will be required to understand the tax treatment applied by the issuer. Additional disclosures setting out the expected tax analysis may therefore be required in the published information as part of the terms of issuing an instrument. However, it would not be practical for the issuers to obtain the same information from a third party holder who would be unlikely to disclose this type of information. Market disruption would undoubtedly result, making it much more difficult and expensive for business to raise finance.

***6. What definition could be used to capture the concept of widely-held or regularly traded whilst also addressing concerns that any exemption should not be available to related parties, parties acting in concert or parties to a structured arrangement (i.e. an arrangement designed to obtain the benefit of a mismatch).***

The use of a bottom up approach removes the need to define the concept of widely-held or regularly traded. As discussed above, the use of a top down approach which targets related party transactions and structured arrangements will address the areas of most significant concern without the need to draw the net more widely or increase the administrative burden for other types of arrangements.

***7. If the rule exempted certain traded instruments then how could it be drafted so that it still applied to structured arrangements?***

A bottom up approach is recommended as it avoids the need to address this point.

***8. In relation to regulatory capital***
***(a) What are the regulatory requirements for banks' to issue/manage capital at top holding company level, and what arrangements are used to pass this down the group? For example, what use is made of identical and traceable instruments and under what conditions would the arrangement be funded by a market issuance at top holding company level?***
***(b) Are special provisions needed to create parity between a banking group issuing hybrid regulatory capital indirectly to the market through its holding companies and a banking group (or another industry group) issuing hybrid regulatory capital directly to the market?***
***(c) Are hybrid regulatory capital instruments sufficiently different as to justify a full carve-out from hybrid mismatch rules? Are there inherent safeguards in place against the use of these instruments for tax-planning purposes or what safeguards could be introduced to ensure that any exemption from the general hybrid mismatch rules could not be abused?***

As noted in the Discussion Draft there is a desire by some regulators to centralise external capital issuances in the head-office jurisdiction (and one legal entity) to help facilitate the potential recovery and/or resolution of failing banks (so called “single point of entry”). In such a scenario, the head office entity would then push down the capital to its regulated subsidiary through the issuance of an intra-group regulatory capital security mirroring the exact terms of the external instrument. This intra-group instrument could meet the definition of a hybrid financial instrument if there is asymmetry in taxation between the

head office jurisdiction and the jurisdiction of the regulated subsidiary. The same issues as arise for banks may also arise for insurers.

This is an example of the potentially negative effects of the proposals, which would therefore appear to encourage banks or insurers to issue capital from regulated subsidiaries directly to third parties in the market, an outcome which could be counter to regulatory objectives. Adding a tax obstacle in the way of regulators working to solve the "too big to fail" problem would appear unhelpful.

Therefore the case for specific rules designed to reduce the impact of the hybrid mismatch proposals on banks' and insurers' issuance of regulatory capital should be considered in the light of evidence about the wider commercial constraints arising from the regulatory environment. For example, Regulated Financial Institutions could be carved out of the hybrid mismatch rules where they are issuing regulatory capital securities which qualify and form a component of AT1 or Tier 2 capital (consistent with the approach taken by jurisdictions such as the UK to give a tax deduction on payments on such securities).

**3. <u>Hybrid Entity Payments</u>**

***1. Is it clear what elements need to be present in order for the rules neutralising deductible hybrid entity payments to apply?***

Please refer to our general comments in Section 1 above.

***2. Is the outcome of the rules' operation clear?***

Para 181 sets out an approach for the prevention of stranded losses, and recommends that excess duplicate deductions should be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the deduction cannot be set-off against the income of any person under the laws of the other jurisdiction. Different tax authorities may approach this type of discretionary power in different ways. Further guidance will be needed to give business comfort that this type of relief will be available in practice and will not be subject to unreasonable or impractical requirements by the tax authority to evidence the position in the other jurisdiction.

***3. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?***

***4. Are there any related party structures where the hybrid entity may have difficulty in knowing or obtaining information about the position of the investor?***

Please see our comments above in respect of information requirements and related parties.

***5. If so when would these arise and what difficulties or constraints would the hybrid entity face?***

Please see our comments above in respect of information requirements and related parties.

**<u>4. Imported Mismatches and Reverse Hybrids</u>**

***1. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?***

2. ***Is it clear what elements need to be present in order for the defensive rule neutralising reverse hybrids and imported mismatches to apply?***
3. ***How could an anti – abuse provision be drafted so that it prevents otherwise unrelated parties from entering into arrangements to exploit mismatch arrangements?***

Imported mismatches and reverse hybrid arrangements are complex in nature, inevitably resulting in complex recommendations which will have an implementation cost for tax authorities and tax payers alike. It is likely that instances of double taxation would arise in some circumstances.

We recommend that the OECD does not make recommendations in this limited area but instead monitors the position after the main recommendations take effect. Further study is in any event needed.

## 5. Further Technical Discussion and Examples

1. ***Do these technical recommendations assist in understanding and applying the rules?***
2. ***Are there further technical recommendations that should be addressed in the final report?***

The technical recommendations are helpful in determining how the rules should be applied. Please see our comments above in respect of the specific areas identified where further information will be required in order for the application of the rules to be fully understood.

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By email: taxtreaties@oecd.orgmailto:

2 May 2014
Our ref: WJID/LS/LKS

Dear Marlies

## Discussion Draft on BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements- Treaty Aspects of the Work on Action 2 of the BEPS Action Plan

Thank you for the opportunity to comment on the non-consensus Discussion Draft in respect of Treaty Aspects of the work on Action 2 of the BEPS Action Plan released on 19th March 2014 (the 'Discussion Draft').

Treaties are designed to promote cross-border trade and investment by protecting against the risk of double taxation and to provide certainty of tax treatment. We support the position that treaty relief should not be available where the treaty conditions are only met through abuse.

We have included our comments on each of the areas identified in the Discussion Draft below.

### (1) Ensuring that dual resident entities are not used to obtain the benefits of treaties unduly

The Discussion Draft notes the interaction with the proposals resulting from the work on Action 6 (Preventing Treaty Abuse) included within the Discussion Draft released on 14 March 2014 (Preventing the granting of treaty benefits in inappropriate circumstances) ('Treaty Abuse Discussion Draft'). As requested, our comments about the proposed change to Art.4(3) were included in our response to the Treaty Abuse Discussion Draft. In particular, we consider that the removal of the effective management test for determining corporate residence would significantly increase uncertainty and put greater pressure on competent authorities. Tax abuse through dual-residence can be tackled through domestic laws.

The Discussion Draft is concerned that the change to Art.4 (3) will not address all BEPS concerns related to dual-resident entities, particularly in relation to avoidance strategies resulting from an entity being a resident of a given State under that State's domestic law whilst, at the same time, being a resident of another State under a tax treaty. We have positive experience of the UK rules operating effectively in this area.

**(2) Ensuring that transparent entities are not used to obtain the benefits of treaties unduly**

*Clarification for transparent entities*

The Discussion Draft proposes to include in the OECD Model Tax Convention provisions and commentary to ensure that income of wholly or partly transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the Partnership Report. The principle of these proposals is welcomed and will help to clarify the current position, particularly in respect of partially transparent funds. The wording of the proposed amendments to Article 1 and commentary should be clear and consistent and not restrict transparent entities from meeting the conditions unless such a restriction is in line with the policy intention.

For example, the income of a UK pension fund is primarily tax exempt under UK domestic law. The wording within the proposed amendments to Article 1 refers to the income of a resident such that it is anticipated that a UK pension fund would be eligible to benefit under the treaty. We note however, that the commentary in respect of this article refers to 'taxable income'. A UK pension fund is not subject to tax on its income and therefore this condition would not be met. Consistent terminology in line with the policy intention of the provisions should be used throughout both the article and the commentary.

There is an opportunity to further clarify whether the attribution of income to fixed bases and/or permanent establishments is to be undertaken at the level of the transparent entity rather than at the level of the partner or investor. This was covered in the Partnership Report at example 12 but continues to be a practical problem which often results in double taxation without any relief. In addition, recommendations should be made to provide consistency where a transparent entity has different sources of income (e.g. domestic and foreign-source, or dividends and gains) and the method of attribution of income to partners or investors (i.e. commercial profit sharing ratios, pro-rata).

The work on the recommendations in respect of Action 2 and 6 present the opportunity to establish consistency and certainty in respect of the above points.

*Verification of person's entitlement to benefits*

Paragraph 26.6 of the proposed commentary on Article 1 confirms that States should not be expected to grant the benefits of a bilateral tax convention in cases where they cannot verify whether a person is truly entitled to these benefits. If a Contracting State cannot obtain tax information it might instead use a refund mechanism. On the basis that efficient systems are the most effective, we strongly support the ability for taxpayers to obtain relief at source where the required information has been provided.

In general, refund mechanisms are administratively burdensome, costly and time consuming for taxpayers and tax administrations and should therefore be reserved for cases where tax information has not been provided. In order to give taxpayers certainty over the type of information required by tax authorities in order to preserve relief at source, guidance should be given on information reporting requirements that could be incorporated into domestic law.

The recommendations in respect of provision of information may exacerbate an existing problem which currently exists for partnerships, particularly those in the small and medium sized sector. Many Contracting States require residency certification from each country where a partner of the

partnership is resident, along with details of each partner's percentage ownership. For partnerships with a large volume of partners whose composition frequently changes the paperwork requirement is significant. In many cases, the individual payments to partners are relatively small such that the administrative burden of providing the level of information required outweighs the benefit of claiming treaty benefits. The recommendations should help to address this issue. For example, a standard format residency certification could be introduced, with transparent entities providing self-certification, subject to tax authority audit.

At its meeting in January 2013, the Committee on Fiscal Affairs approved the TRACE ("Treaty Relief and Compliance Enhancement") Implementation Package. The work completed on the TRACE project was supported by industry and confirmation should be provided as to how the proposed changes to the OECD Model Tax Convention interact with TRACE.

**(3) Interaction between the recommendations included in the WP11 Discussion Draft and the provisions of tax treaties**

*Exemption and credit method*

The credit method can be administratively burdensome for taxpayers and tax authorities, and in general the exemption method is simpler and, in many cases, preferred. It is appropriate that the exemption method should be replaced with the credit method in respect to dividends that are deductible in the payer state. For example, the UK dividend exemption operates on this basis and is not available where a deduction is allowed in the payer state.

We note that the European Commission is also looking at this issue and proposed changes to the Parent-Subsidiary Directive announced on 25 November 2013. The EC proposal aims to tighten the provisions so that hybrid loan arrangements cannot benefit from tax exemptions.

If you wish to discuss any of the points raised in this letter, please do not hesitate to contact me (bdodwell@deloitte.co.uk).

Yours sincerely

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May 2, 2014

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

[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.

[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.

* * *

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

[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
Partner

Gretchen Sierra
Principal

Harrison Cohen
Director

N O B

de Nederlandse Orde van Belastingadviseurs
The Dutch Association of Tax Advisers

Attn. Mr. Achim Pross
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*By email:* aggressivetaxplanning@oecd.org

24 April 2014

**RE: NOB commentary to the OECD's Public Discussion Drafts entitled: "Neutralise the effects of Hybrid Mismatch Arrangements"**

Dear Mr. Pross,

The NOB[1] welcomes the opportunity to respond to the OECD's Public Discussion Drafts entitled: "Neutralise the effects of Hybrid Mismatch Arrangements", as published on 19 March 2014.

First, we would like to express our support for the OECD's efforts to develop model treaty provisions and recommendations regarding the design of domestic rules on the subject of the tax treatment of hybrid instruments and entities. In addition, in particular in light of the current economic times, we can appreciate the desire for creating anti-tax base erosion measures.

Nevertheless, we are concerned that the measures as proposed specifically in the first discussion draft, "Neutralise the effects of Hybrid Mismatch Arrangements – Recommendations for Domestic Laws", cannot achieve the policy objectives in their current forms. Below we outline our main concerns and recommendations.

Concerns

1. The report is extremely ambitious and the interplay of the hybrid mismatch (linking) rules proposed is particularly complex. For these reason, we expect that the measures proposed will not (or only to a limited extent) be implemented in a considerable number of (non-OECD) countries.

[1] The Nederlandse Orde van Belastingadviseurs or NOB (in English: The Dutch Association of Tax Advisers) is the professional association of the university educated tax advisers in the Netherlands. The NOB, which was established in 1954, has 4,900 members, including 900 prospective members.

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2. The hybrid mismatch (linking) rules proposed are formulated as recommendations. We anticipate that the non-binding character of the rules will result in countries not taking the necessary implementation steps. We are apprehensive that such approach - likely driven by local policy considerations – may result in new mismatches, possibly giving rise to double taxation.

3. The mechanism selected includes both a primary rule (instructing country "A" to act) and a secondary rule (instructing country "B" to act, where country "A" did not). This approach suggests countries effectively have a choice as to whether or not to enact one/both of the proposed rules. We are concerned the mechanism proposed will result in countries (again, likely driven by local policy considerations) picking and choosing rules to their liking.

4. The report focuses on hybrid mismatch arrangements only and does not address preferential tax regimes. Such regimes can often be used to effectively and economically achieve the same / similar results as hybrid mismatch arrangements. We are concerned that, unless hybrid mismatch arrangements and the aforementioned preferential tax regimes are jointly addressed, measures taken will fuel international tax policy competition.

Recommendations

In light of our concerns, we make the following recommendations:

A. We recommend focusing efforts on achievable goals and develop measures that have broad support within the international (OECD) community (compare: proposal of the European Commission for amendment to the EU Parent-Subsidiary Directive addressing hybrid loan mismatch arrangements).
B. We recommend advising the use of "hard law" instruments to enhance effectiveness of the mechanism proposed and avoid policy cherry-picking.
C. We recommend implementing a mechanism including the primary rule only. If the primary rule is correctly implemented (via "hard law") by all countries, the secondary rule is superfluous. Alternatively, a mechanism could be considered under which the primary rule is applied based on reciprocity.
D. We recommend an integrated approach with respect to addressing hybrid mismatch arrangements and preferential tax regimes.

We trust our comments are useful for your discussions. If you have any questions or would like to discuss in more detail, please do not hesitate to contact us.

With kind regards,
The Dutch Association of Tax Advisers

mr. drs. S.D. Brunner
member of the board of the Dutch Association of Tax Advisers

Building a better working world

2 May 2014

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Centre for Tax Policy and Administration
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## Comments on OECD Discussion Drafts on Neutralizing the Effects of Hybrid Mismatch Arrangements

Ladies and Gentlemen:

EY appreciates the opportunity to submit these comments to the OECD on the Discussion Drafts on Neutralizing the Effects of Hybrid Mismatch Arrangements dated 19 March 2014.

The Discussion Drafts set forth ambitious proposals for domestic law and treaty provisions with respect to the tax treatment of specified hybrid transactions and arrangements. We recognize the importance of considering and addressing tax policy concerns associated with certain cross-border transactions and arrangements that give rise to disparate tax treatment under the domestic tax laws of the two or more countries involved. However, we would note that the proposal advanced by the OECD in the Discussion Drafts would seem to have broader implications for tax sovereignty that deserve careful consideration. The proposal is a construct of domestic laws that would condition the local tax treatment of a particular arrangement based on the tax treatment of the other side of the arrangement in another country. While tax treaty provisions often are negotiated based on the applicable domestic law tax treatment in the treaty partner, what the OECD is advocating here is a system of domestic laws that would operate unilaterally and automatically but would be conditioned on tax policy choices made in another country.

We urge the OECD to act cautiously so as to ensure that its proposals to address hybrid mismatch arrangements are appropriately integrated with the relevant domestic law rules of countries and with the proposals for domestic law and tax treaty changes that are being developed in connection with other aspects of the OECD's Action Plan for Addressing Base Erosion and Profit Shifting.

### Implications of the Complexity of the Proposed Approach for Addressing Hybrid Mismatch Arrangements

The Discussion Drafts set forth a proposed construct for the treatment of hybrid transactions and arrangements that is exceedingly complex. The construct involves a set of primary and secondary rules and defensive

responses, with different rules for each of the several categories of hybrid arrangements that are covered. This construct seems more complicated than any domestic law regime of any country in place today. Moreover, this construct envisions the global adoption of rules that must then mesh very precisely across the two or more countries involved in any particular transaction or arrangement.

It does not seem possible that countries could adopt and interpret this construct in a completely consistent way. Indeed, the proposal leaves key concepts and definitions open with the idea that these details are to be filled in by each country. Moreover, each country would need to incorporate the proposed construct for the treatment of hybrid arrangements into its existing domestic law, including what in some cases are significant rules on hybrids that are already in place. While some countries might choose to replace their existing rules with respect to hybrid arrangements with this new OECD regime, it seems likely that many countries would instead layer the new regime on top of their existing rules.

Countries also would have to address a whole range of collateral consequences associated with the treatment of hybrid arrangements. This would require the meshing of the proposed regime for hybrids with many elements of each country's domestic law tax rules for financial transactions. Examples of some of the kinds of collateral consequences that would have to be addressed under each country's own tax system include:

- The impact on the debt-equity analysis of other debt;
- The implications under earnings stripping rules;
- Characterization as equity for other tax purposes;
- The implications under rules regarding multiple classes of stock;
- Withholding tax treatment;
- Foreign exchange gain or loss consequences such as amount and timing; and
- Foreign tax credit implications.

In addition, presumably each country would need to adapt the proposed construct for hybrids to its own overall customs and practices with respect to the tax law. This would include matters like preferences for detailed and specific rules versus more conceptual approaches and availability of rulings or other advance clearance procedures.

In considering the OECD's proposed approach for the treatment of hybrid mismatch arrangements, it must be acknowledged that what would result almost certainly would not be coordinated country to country as is intended in the abstract. This means that advancement of the proposal necessarily would involve substantial uncertainty and significant risk of double taxation. These implications should be taken into account as alternatives are considered, including the potential for addressing the tax policy concerns with respect to hybrid arrangements under the proposals under development in connection with other action areas in the OECD's BEPS Action Plan.

**Importance of Interaction with Work under Other BEPS Actions**

There is significant overlap between this Action 2 on addressing hybrid mismatch arrangements and several other aspects of the OECD's BEPS Action Plan. The overlap is perhaps most pronounced in the case of Action 4 on limiting interest deductibility. Other action areas where there is real potential for overlap include Action 3 on strengthening CFC rules, Action 5 on harmful tax practices, and Action 6 on addressing treaty

abuse. The work on Action 6 and some of the work on Action 5 is being done simultaneously with the work on hybrids, but the work on Actions 3 and 4 will not begin in earnest until after recommendations with respect to hybrids are delivered and recommendations in those areas are not expected to be delivered until a year after the delivery of the hybrids recommendations.

We believe that some of the issues with respect to hybrids could be dealt with more naturally under these other Actions. The work on Action 4 will focus on issues with respect to leverage and financing. In order to address those issues in a comprehensive way, hybrid financing arrangements should be included within the scope of that project. Moreover, addressing hybrid arrangements as part of that work would be necessary to ensure that the recommended approach with respect to the treatment of leverage takes into account all aspects of a business's leverage profile. Alternatively, addressing hybrid financing arrangements separately only under Action 2 would seem to be a piecemeal approach. And addressing such arrangements under both Actions without appropriate coordination would adversely affect the recommended approaches under each of these Actions.

Ideally, work on these other Actions would be completed first, before turning attention to the work on hybrid mismatch arrangements. The other Actions are simpler than Action 2 in the sense that the focus is on the country's domestic law rules only or, in the case of Action 6 on addressing treaty abuse, is on bilateral agreements between two countries. This would seem to be easier to manage than the proposed construct with respect to hybrid mismatch arrangements, which is centered on each country's domestic law rules but requires specific and granular coordination of another country or countries' domestic law rules with the rules of the first country.

If the work in these other areas were to be completed first, the OECD could then assess the extent to which issues with respect to hybrids remain. Any remaining issues could be dealt with using hybrid specific rules in a more targeted way. Approaching it from the other direction, which would require that the subsequent work on interest deductibility, CFC rules and harmful tax practices be designed around the proposed hybrid regime, would be difficult and would seem to risk making those rules more complex than otherwise would be necessary.

Giving primary focus to the work under Action 4 on interest deductibility also would facilitate a more comprehensive approach for addressing inconsistencies between countries' tax treatment of financial transactions. The proposed construct for hybrid mismatch arrangements is aimed at addressing asymmetries in tax treatment that result in what the OECD views as double non-taxation. However, in the interests of fairness and equal treatment, the OECD similarly should address asymmetries in tax treatment that result in double taxation. Thus, where a thin capitalization regime or other limitation on interest deductibility causes interest expense to be non-deductible in one country, there should be a corresponding adjustment of the income inclusion in the other country. This would help to reduce instances of effective double taxation, although it is not expected that such coordination rules would completely eliminate the potential for double taxation in this area. We urge the OECD to include in its work on Action 4 and the deductibility of interest consideration of approaches for accomplishing a coordinated and symmetrical approach to the treatment of leverage and interest expense. The ability to develop balanced and symmetrical rules regarding the appropriate location of debt and the associated interest expense is a further reason to favor interest deductibility rules overall as the first defense against hybrid mismatch arrangements and to look to hybrid specific rules under Action 2 only as a backstop where necessary to address hybrid arrangements that are not fully captured in such leverage rules.

We would recommend that the implementation work with respect to the proposed construct on hybrid mismatch arrangements be deferred until the work on developing recommendations with respect to these other Actions is completed. This would allow for appropriate coordination of the recommendations, including what is likely to be a significant narrowing of the required reach of the rules on hybrids due to many of such arrangements being directly addressed through the rules on leverage that will be recommended for example. In order to avoid exacerbating complexity and increasing both uncertainty and the risk of double taxation, coordination of the solutions in all these Action areas will be critically important.

**Need for Narrow Approach**

The complexity of the proposed hybrid mismatch arrangement approach and the need for coordination with the work on other Actions, most particularly the recommendations for limiting interest deductibility being developed under Action 4, provide significant support for use of the "bottom up" approach set forth in the Discussion Drafts. The reach of the proposed treatment of hybrids should be narrowly targeted, with only specified categories of hybrid mismatch arrangements covered. This would allow time to consider the implications in practice of the proposed approach. It also would allow time to evaluate the impact that the work done under the other Actions has on the continued use of such arrangements and to determine the extent to which hybrid-specific rules are needed once the rules developed in other areas of the Action Plan have been put in place.

The initial scope of rules addressing hybrid mismatch arrangements should focus on related party transactions. Moreover, for this purpose, the scope of the "related party" concept should be limited to situations involving a control relationship. Therefore, the threshold for related party status should be set at more than 50% rather than at the 10% level proposed in the Discussion Drafts. We further believe that the use of the concept of "acting in concert", which is subjective and can be highly contentious, is not advisable in this context where clarity and certainty of scope is essential.

In considering any extension of the proposed rules to cover certain arrangements between third parties, it is our view that the concept of a "structured transaction" is not one that can be readily defined at the OECD level. Rather, this is more naturally a concept to be determined consistent with each country's domestic law. Therefore, we urge the OECD to leave the treatment of hybrid arrangements between unrelated parties to be addressed in countries' domestic law. Any new rules in this area should be implemented on a prospective basis and should be clear and targeted so as to minimize disruptions to the capital markets.

This initial narrow coverage of the recommended construct for hybrid mismatch arrangements could be expanded, contracted or adjusted as appropriate, after the OECD and member countries assess the experience gained and evaluate the new landscape with respect to hybrid arrangements in light of the domestic law and tax treaty changes implemented in connection with the work under other Actions.

**Need for Coordination with Domestic Law Anti-Abuse Rules**

The OECD's proposed construct with respect to the treatment of hybrid mismatch arrangements starts from the base of the relevant countries' domestic law treatment of the arrangement in question. Even with the narrow approach we recommend, it is necessary that the treatment of a hybrid transaction or arrangement in one

country is known and fixed in order to determine the treatment that should be applied in the other country. Any uncertainty or change in the treatment in the first country could mean that the treatment in the second country does not lead to the intended overall result. Indeed, the result could be unintended double taxation if one country's treatment is changed and the other country's treatment cannot be changed because of statute of limitations issues or lack of coordination or other reasons.

Because the key to the OECD's proposed construct on hybrid arrangements is coordination of the treatment of the arrangement in two or more countries, domestic law GAAR provisions should be made inapplicable to hybrid arrangements that are covered by such construct. The construct is based on a system of primary and responsive actions. After-the-fact application of a domestic law GAAR in one country would have implications for the appropriate responsive action, but it may well be too late for the tax treatment of the arrangement to be changed in the country that is in the responsive posture. Therefore, a rule protecting against application of domestic law GAAR provisions should be an integral part of the proposed approach on hybrids.

The applicability of domestic law GAAR provisions also must be addressed in the context of transition. With the implementation of the OECD's proposed approach to hybrid arrangements, taxpayers may well choose to refinance existing financial arrangements rather than to keep in place a hybrid arrangement that is targeted under the new regime. A taxpayer may refinance a disfavored hybrid instrument into a straight debt instrument for example. In this regard, one of the intended results of the proposed hybrid construct is to discourage use of such instruments in favor of other instruments that do not have hybrid characteristics. A transaction that is undertaken to replace a disfavored hybrid instrument with another form of financing should be protected against any potential challenge that could be brought under a domestic law GAAR based solely on the fact that the refinancing is driven by the enactment of new rules on the tax treatment of hybrid arrangements. Therefore, a rule protecting such refinancings against application of domestic law GAAR provisions also should be an integral part of the recommended construct for treatment of hybrid mismatch arrangements.

**Need for Coordination with Other Aspects of Domestic Law**

Just as it is essential that the proposed approach for the treatment of hybrid mismatch arrangements be coordinated with the domestic tax law of the affected countries, it also is critically important to ensure that the new construct does not interfere with other regulatory regimes at a domestic or multilateral level. As noted in the Discussion Drafts, a key focus in this regard is ensuring that any new rules with respect to the treatment of hybrids do not apply in a manner that undercuts the regulatory capital requirements applicable to regulated financial services businesses. The ability of a global financial institution to use new forms of capital as mandated by the regulators and to bring in capital from the market only at the top holding company level as favored by the regulators and then to push the capital down to the group entity where it is needed should not be impeded by recommended changes in the tax treatment of hybrid arrangements.

Therefore, we encourage the OECD to continue to work with the financial services industry and with the relevant industry regulators so that the interaction of the recommended approach for the tax treatment of hybrid mismatch arrangements and the applicable regulatory capital rules does not lead to inappropriate and unequal results across financial institutions with different global profiles.

*****

If you have questions or would like further information regarding any of the points discussed above, please contact Barbara Angus (barbara.angus@ey.com), Jim Tobin (james.tobin@ey.com), or me (alex.postma@ey.com).

Yours sincerely
On behalf of EY

Alex Postma

Ref.:EBF_007866

Brussels, 5 May 2014

**Mr Achim PROSS**
Head of the International Co-operation and Tax Administration Division
Centre for Tax Policy and Administration
OECD

Email: aggressivetaxplanning@oecd.org

*Subject: EBF Comments on BEPS Discussion Draft on Hybrid Mismatch Arrangements*

Dear Mr Pross,

The European Banking Federation (EBF)[1] welcomes the opportunity to comment on the OECD's current work on neutralizing the effects of hybrid mismatch arrangements, Action 2 of the Base Erosion and Profit Shifting (BEPS) project.

The EBF believes that the recommendation in BEPS Action 2 may lead to a very broad set of rules that would be extremely burdensome to manage. It may also be contradictory if the tax administrations introduce locally tailored legislation based on different approaches.

Some countries may introduce an anti-abuse rule in their legislation. The tax administration expects to have prevented a tax planning opportunity and the intention is that the structures should not be used. In other countries the approach may be that there should be freedom to arrange financial transactions.

Legislation based in BEPS Action 2 recommendations is therefore unlikely to be uniform. Every country has its own concepts how to legislate and may also consider to use the same legislation for more than one purpose. This would most likely lead to an administrative burden for the tax payer when attempting to comply with different rules in different jurisdictions.

The EBF is very concerned that it will be impossible to fulfil all design principles as specified in paragraph 27. In order to not hamper international business and commerce, we therefore strongly urge the work group to introduce a carve-out in order to exempt all common and 'plain vanilla' transactions and exclude as much ordinary transactions as possible from the hybrid mismatch legislation. The targeted transactions should be limited to the tailor-made 'boutique constructions' with the primary reason to take advantage of the tax mismatch.

[1] Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interest of some 4,500 banks, large and small, wholesale and retails, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

Additionally, the approach of automatic application of the rules, without considering the existence of a real business purpose of the arrangements, may affect to the plain vanilla instruments and arrangements widely used in the markets for business reasons aside any tax planning concern; for example, the collateralised loan repo as an efficient tool widely used in the markets to raise funds and liquidity.

The following are examples of instruments that would benefit from a carve-out rule:

- Commonly and/or publicly traded financial instruments
- Financial transactions between unconnected parties
- Regulatory capital

Further to the above general comments, we would like to provide comments to the specific point in relation to regulatory capital raised in box 2 (page 43) on the discussion draft:

***8. In relation to regulatory capital***

Regulatory capital in banks is governed by Basel III and in EU by Regulation 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms. This means that the criteria to identify such financial instruments are agreed at global level and are designed to make the banking sector resilient.

The Basel III framework states that banks' regulatory capital is composed by Common Equity Tier 1, Additional Tier 1 and Tier 2. Banks should issue regulatory capital in order to be compliant with the relevant regulation.

The main difference between Basel II and Basel III frameworks lays on the provision which requires banks to convert their additional Tier 1 (and potentially Tier 2) instruments into Common Equity Tier 1 at a trigger point, already defined in the relevant legislation. This leads to the creation of a new types of regulatory capital instrument that convert to equity at a pre-defined trigger point, and therefore could be addressed as "hybrid" in addition to those that are hybrid because of contractual provisions.

This being said, it is now evident that all banks' regulatory additional Tier 1 and Tier 2 (AT1 and T2) capital should be addressed as "hybrid regulatory capital instrument" which arise from a regulatory provision (legally binding for banks) and not from an aggressive tax planning. The EBF therefore argues that the hybrid regulatory capital i.e. AT1 and AT2 should be excluded from hybrid mismatch arrangements.

***Question 8 (b)***
***Are special provisions needed to create parity between a banking group issuing hybrid regulatory capital indirectly to the market through its holding companies and a banking group (or another industry group) issuing hybrid regulatory capital directly to the market?***

In the example in paragraph 159, one jurisdiction in a group treats the hybrid regulatory capital as equity and the other jurisdiction as a loan relationship. This would lead to a different tax treatment when one banking group would issue the external hybrid regulatory capital from

the holding company/parent company and cascade the loan down to the subsidiary bank and another group would have a right to let the subsidiary do the borrowing directly. Whether or not this will give an actual effect on the bottom line would depend on the tax legislation in the jurisdictions involved.

If a full carve-out from hybrid mismatch rules is not feasible it should at least be possible to have a neutral intra-group treatment in situations where the cascading is compulsory.

***Question 8 (c)***
***Are hybrid regulatory capital instruments sufficiently different as to justify a full carve-out from hybrid mismatch rules? Are there inherent safeguards in place against the use of these instruments for tax-planning purposes or what safeguards could be introduced to ensure that any exemption from the general hybrid mismatch rules could not be abused?***

The issuance of any AT1 or other regulatory capital has to be approved by the issuing bank's supervisory authority. The main reason for issuing such capital will always be to manage solvency and/or ratings, and tax-planning would be out of scope. Another point is that the investors will usually seek for clearance that there are no tax issues that could lead the borrower to call the loan prematurely, for example the risk that interest payments will be non-deductible. Given that it is unlikely that these loans should be issued solely for tax planning purposes, hybrid regulatory capital should be fully carved out from the hybrid mismatch rules.

We appreciate your consideration of our comments and suggestions and remain at your disposal to contribute further as the work develops.

Yours sincerely,

Guido Ravoet

# European Business Initiative on Taxation (EBIT)

**Comments on the OECD's Discussion Draft on**

**BEPS ACTION 2:**
**NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS**

At the time of writing this submission, EBIT Members included: AIRBUS, BP, CATERPILLAR, DEUTSCHE LUFTHANSA, INFORMA, JTI, LDC, MTU, NUTRECO, REED ELSEVIER, ROLLS-ROYCE, SAMSUNG ELECTRONICS, SCA, SCHRODERS and TUPPERWARE.

Achim Pross
Head
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OECD
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FRANCE

Brussels, May 2014

Dear Achim,

EBIT welcomes this opportunity to provide comments to the OECD on the Discussion Draft on BEPS Action 2: "Neutralise the effects of hybrid mismatch arrangements" which was issued on 19 March 2014 (hereinafter "the Discussion Draft").

## General Comments

EBIT supports the OECD's work to address cross-border hybrid mismatch arrangements and we generally acknowledge the political importance and sense of urgency attached to Action 2 of the BEPS Action Plan.

We support proposals aimed at mitigating the valid concerns of the G20 and OECD about highly structured artificial arrangements to exploit mismatches between tax jurisdictions. At the same time, such rules should not give rise to double taxation and other unintended consequences for genuine cross-border businesses and they should ensure a level playing field, and coherent international tax system.

EBIT welcomes the fact that the OECD acknowledges in its Discussion Draft that hybrid mismatches arise as a result of governments taking different positions on the taxation of hybrid instruments or entities, and that it is frequently difficult or impossible to identify which government has suffered loss. As in much of the BEPS project, this is not a case of tax avoidance as previously understood; there can be no avoidance where there is no intent to tax in the first place. The tools to deal with non-taxation will not be the same as those used for avoidance. This should be remembered in particular where penalty and interest regimes are involved.

A key point in our view is that international co-operation is paramount in addressing the issue of hybrids. If all 42 states supporting the BEPS project do not adopt measures to ensure single taxation of hybrids, there is potential for substantial tax asymmetry to remain for companies resident in those non adopting states as well as potentially in countries not participating in the BEPS project. This could lead to distorted tax competition. We anticipate that this may be a particular issue with hybrids involving entity classification, where it may be difficult for certain states to change their domestic rules. This might lead to a situation where some of the states initiate partial measures,

some none at all and some comprehensive measures, leaving continuing opportunities for companies resident in the states with no or partial measures to receive a "subsidy" from the international tax system not available to those in states where the measures are comprehensive. It could also lead to increased disputes over the balanced allocation of taxing rights across jurisdictions. Because of this risk, the OECD should be providing guidance or recommendations on implementation from an agreed future date to allow coordinated action.

Adding to the previous point, with regard to hybrid financial instruments, EBIT notes that the OECD's proposed counteraction is not consistent with the work undertaken in the context of the EU. The EU is about to finalise a revision of its EU-wide Parent Subsidiary Directive, which was announced in November 2013 as part of the EU's December 2012 Action Plan to combat tax fraud and tax evasion and aggressive tax planning within the EU. The EU Parent Subsidiary Directive proposed changes provide that where a parent company, by virtue of its association with its subsidiary, receives distributed profits, the EU Member State of the parent company shall refrain from taxing such profits only to the extent that such profits are not deductible by the subsidiary of the parent company. This solution will now be incorporated into all national laws across the EU by 31 December 2015 at the latest. We are concerned that the EU and OECD are recommending inconsistent solutions to the same problem since the EU counteraction focuses on the recipient, whereas the OECD counteraction focuses on the payer country. We would not wish for "double jeopardy" for taxpayers whereby EU law prescribes recipient countries to tax profits on hybrid instruments whilst the OECD simultaneously requires the payer countries to disallow them.

The proposed anti-hybrid recommendations in the Discussion Draft would give rise to another EU Law problem. As the new rules will be implemented as domestic anti-abuse rules, under EU Law (i.e. the free movement of capital rules and settled case law of the EU's Court of Justice including *Test Claimants in the Thin Cap Group Litigation* (C-524/04: see in particular paragraph 92) and *Itelcar* (C-282/12), this would trigger a "commercial purpose" justification with regard to the anti-abuse test i.e. that the taxpayer must be allowed to demonstrate that the arrangement had been adopted for commercial reasons and not solely for tax reasons. EBIT is concerned that this test is compulsory only in the 23 EU/EEA OECD countries supporting BEPS, and will lead to different (tougher) anti-abuse standards being applied with respect to anti hybrid mismatch rules within the EU/EEA region than elsewhere.

EBIT notes that a distinction is drawn by the OECD in its Discussion Draft between the tax effects of hybrid arrangements and other types of mismatches resulting from the fiscal policies of different countries. Hybrid arrangements are only one of the factors that can result in cross-border tax mismatches. Yet the OECD does not really provide a rationale for why it has decided to focus on hybrid mismatches. For example, tax rate differences affect location decisions, but this is a fundamental aspect of countries' sovereignty and tax competition and as such out of scope. In our view rationalising why other types of mismatches are (rightly) not under consideration as well is crucial to making the anti-hybrid proposals more proportionate and more targeted.

The OECD's work on hybrids should also be closely coordinated with the work on CFCs (Action Point 3), Interest Deductions and other Financial Payments (Action Point 4), and also Harmful Tax Practices (Action Point 5), however, the OECD is not scheduled to report until September 2015 on these Action Points. To ensure that the OECD sticks to its holistic approach and proposes proportionate and well-balanced final recommendations which do not create unintended consequences or an un-level playing field and take the impact of the proposals under these other BEPS actions fully into account, we urge the OECD not to finalise its work on Hybrids in advance of its work on CFCs, Interest Deductions and Harmful Tax Practices.

From our daily experience, it seems to us that the intrinsic highly technical and practical complexity associated with the anti-hybrids rules, the associated administrative compliance aspects for taxpayers and tax administrations, and the related uncertainty and scope for unintended ramifications of the rules, are either being misjudged or downplayed by the OECD. Two examples can illustrate this point. First, due to their wide scope, the proposed rules imply that taxpayers who

are part of a genuine international business not engaging in hybrid mismatch arrangements would nevertheless be required to confirm that all their routine commercial transactions are outside the scope of the proposed anti-hybrid rules. It is obvious that such a provision would impose a significant extra administrative compliance burden on taxpayers without exception and that the rules will distort international competition, trade and investment flows. Secondly, in the recommendations for domestic laws in the Discussion Draft, a taxpayer's claim to a deduction or inclusion is linked to whether a deduction or inclusion is granted or required in another jurisdiction. This would mean that taxpayers would be required to assess how the arrangement is to be treated in their domestic jurisdiction and also be aware of how it is to be treated in the jurisdiction of their counterparties, i.e. information is to be obtained from third parties or entities that are not within their control. These above two examples illustrate that it is critical that the draft rules be re-designed in order to be workable for taxpayers and to keep the compliance costs to a minimum.

EBIT is strongly in favour of a bottom up approach, because as tax practitioners, we firmly believe that a top down approach, where all hybrids are within scope unless specifically excluded, would be very difficult and costly to manage in practice.

EBIT considers that the affiliation threshold applying to a related party should be based on the notion of control, in this case the ability to obtain the necessary compliance information from the affiliate. The threshold should therefore be set at either 50.1% or at a minimum 25% instead of the proposed 10% because otherwise compliance will be made disproportionately burdensome, in particular for Joint Ventures and collective investment vehicles.

EBIT is concerned about the proposals with regard to reverse hybrid situations. To illustrate: if the investor jurisdiction (country A) and the investee jurisdiction from which payment is ultimately made (country C) both decide neither to include that payment (A) nor to disallow the deduction (C), should an intermediate third country (B) from which there is maybe a non-hybrid payment to country A, be automatically required to disallow the deduction under the proposed rules? The intermediate country B is being required to disallow a payment to the ultimate investor country A where neither the primary rule is applied, i.e. investee country C payer disallows, nor the secondary rule, i.e. ultimate investor country A taxes. If the latter (Country A) is the US for instance, as reverse hybrid situations are almost always US outbound, they may well not tax because of either check-the–box or the scope of Subpart F. Hence, in our view this could potentially export US/investee country non-compliance with hybrid counter-action to the intermediate country.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this area. We are happy to discuss and remain committed to a constructive dialogue with the OECD.

Yours sincerely,

**The European Business Initiative on Taxation – May 2014**

For further information on EBIT, please contact its Secretariat via Bob van der Made, Tel: + 31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com).

CC: Pascal Saint-Amans

**Submission**

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CREATING LASTING VALUE

**2 May 2014**

**To** **Organisation for Economic Co-operation and Development (OECD)**

**Re** **Consultation on Public Discussion Draft BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements.**

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## Introduction:

The European Private Equity and Venture Capital Association (EVCA) is pleased to provide its comments on the public discussion draft released by the OECD on Action 2 ("the consultation document").

The EVCA's membership covers the full range of private equity activity, from early-stage venture capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions.

The EVCA fully appreciates the concerns of the OECD that action is needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it.

The EVCA endorses the response of the British Private Equity & Venture Capital Association (BVCA) as the content of their response also reflects our views.

## How Private Equity Operates:

Private equity (including venture capital)[1] funds raise capital from institutional investors such as pension funds, insurance companies, or family offices. These private equity funds are managed by specialist investment managers who invest the capital in companies across a wide variety of sectors, including consumer, industrial, engineering, life sciences, bio-technology, computer software, infrastructure, etc, at various stages of the life of the company.

Most private equity funds have an international investor base. The investors are either subject to corporate income tax in their country of residence (insurance

[1] The term "private equity" is used in this paper to refer to all segments of the industry, including venture capital. The term "venture capital" is used in specific contexts where there are issues that relate particularly to this segment.

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companies, family offices), or are exempt from such tax by their nature (pension funds, charities).

The choice for the private equity fund's location is normally made on the basis of various factors (residence of the management team, investment objective, regional focus). From a tax perspective, it is key that the location and structure of the fund is tax neutral for the investors. In other words, the pooling of the investments via the fund entity should not trigger additional tax for investors when compared with a situation in which the investors invest directly in those companies. This is a general principle for structuring funds which is not unique to private equity.

**BEPS Action 2 in the context of Private Equity:**

Private equity operates very differently from the large multi-national organisations on which the OECD's work on BEPS appears to be largely focused. It is vital that these differences are understood and accommodated in order that the industry is not inappropriately disadvantaged, which would in turn lead to a disruption in global investment flows, impacting countries that rely on inward investment and reducing economic growth across the globe.

Private equity funds use complex financing instruments to meet the needs of both the companies being financed and also the investors. These instruments play an important role in matching those seeking to invest capital with those requiring investment.

Given the broad definition of hybrids, it cannot be excluded that such instruments qualify as hybrids. However, the framework for using hybrids is a function of the tax laws applying to the wide and varied investor base and investment jurisdictions. The acquisition structures are typically not designed to give rise to non-inclusion or a double deduction, but are designed to provide flexibility to remit cash to investors and deal with the different needs of a diverse investor base, trying to ensure that investors pay tax at the time the stakeholders receive a cash return.

A key element of private equity structures is that the imposition of a holding structure should not change the tax attributes for investors and is comparable to the position if the investor made a direct investment and that investor pays tax at the point an investment return is received and not in advance. A change in this principle would reduce investment returns, increase the risk for investors and reduce attractiveness of private equity for large groups of investors. This

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includes significant investors such as major pension funds, governmental funds, insurance companies, life companies, corporate investors etc.

Unlike an international corporate group, a private equity fund has a finite life (usually between five and ten years, often with the possibility of a two year extension). From the outset of an investment, the manager of the fund must be mindful of and plan for this constraint. The mechanism for investing must enable the fund to be able to return all proceeds to investors from the underlying investments within this time-frame as there is no mechanism for returning such proceeds after the private equity fund has run its course. It is this imperative which drives the choice and terms of the instruments used to make the investment which might be a mix of equity, plain vanilla debt and potentially loans which have some equity-like features (so-called 'hybrid' instruments).

A private equity fund cannot and does not attempt to structure its investments to be tax efficient for each investor. But if a particular group of investors face a specific and commercially problematic tax problem, the fund may account for this in its choice of investment instrument. For example, the US tax system taxes investors on an accruing yield basis which would result in investors potentially being taxed before receiving cash from the fund. This is sometimes known as "phantom income" given the uncertainty of the final receipt. To the extent there is a tax advantage in the use of a hybrid instrument in this context, it is a timing advantage, i.e. the use of a loan note which has equity features may mean that tax is due when cash is realised.

Whilst it relatively simple for a corporate group to deal with the different tax attributes of group members, that luxury is not available to a private equity fund as in many cases, it will not have access to full information regarding the underlying nature and tax treatment of the investors. Therefore it will be almost impossible for a private equity fund to deal with provisions on imported mismatches and demonstrate that a deduction should be available.

This instance is illustrated in the consultation document at paragraph 88; "[t]he recommendation is not intended to impact on questions of timing in the recognition of payments. Thus, a hybrid mismatch does not arise simply because the issuer accrues original issue discount over the term of the bond while the holder only recognises the corresponding income as redemption premium once the bond is repaid." This principle should be clearly extended to circumstances where instruments are issued that are designed to trigger taxation in the hands of [taxable] investors only on realisation of economic income and gains.

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Indeed if hybrid instruments or imported mismatches were to be included in the rules simply because of timing differences, then presumably there would need to a relieving mechanism when the timing difference reversed. That might be possible, but would be hugely complex across a diverse investor base. In addition, changes in investors and fund profit sharing ratios would make administering the arrangements almost impossible.

**Use of Hybrid Instruments for Venture Capital:**

Venture capital provides a vital source of both financing and mentoring for young start-up companies. As confirmed in the recent European Parliament Report on Long-term Financing of the European Economy[2], "venture capital and private equity firms can provide valuable non-financial support, including consultancy services, financial advice, advice on marketing strategy, and training" to investee companies. This sentiment has also been echoed in the recent European Commission Communication on Long-term Financing[3], which acknowledges the private equity and venture capital industry as an important source of financing to SMEs.

The Communication acknowledges that companies face financing and education gaps "due in part to limited venture capital funding in Europe." Encouraging private investment into European venture capital remains one of the biggest challenges for the industry. In this light, we urge the OECD to take into account the specific position of venture capital funds and not adopt changes to the tax regime that will discourage such private sector investment.

For various non-tax related reasons, start-ups (young innovative companies) often issue convertible instruments which may be treated as debt in the country of the start-up company, and may be treated as equity in the country of the fund (or its investors). The interest payable on such an instrument may, in theory, create a tax deductible payment for the start up. However, such tax deduction can generally not be effectuated for the next 5 to 10 years, if at all. It generally takes years before a start-up is in a position to make a taxable profit, and it often never achieves a profitable status and the accumulated losses simply evaporate. In such situations, a mismatch effectively does not appear. It would be unfair to tax the investors of the venture capital funds that

[2] European Parliament Own-initiative Report on Long-term Financing of the European Economy, 26 February 2014. Paragraph 38.

[3] European Commission Communication on Long-term Financing of the European Economy, 27 March 2014, pp 6 & 13

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are prepared to finance these start-ups if the corresponding tax deduction is not achieved.

In order to further explain the rationale for the use of certain instruments by private equity funds, we would like to start with a typical example acquisition structure drawn from the consultation document then examine the following issues in turn:

- Imported mismatches
- Hybrid Instruments
- Hybrid entities
- Definitions
- Administration

**Example structure- Imported Mismatches/Reverse Hybrids:**

The structure set out at figure 12 at paragraph 207 of the consultation document entitled "Importing Mismatch from Hybrid Financial Instrument" is a good starting point as this type of structure is relatively common. The structure is designed to provide flexibility in relation to returning funds to stakeholders but also match cash to tax payments in the hands of investors. This might involve the acquisition of a European group using a holding company for example, which is financed by the fund. The fund vehicle, typically a tax transparent partnership, would incorporate an intermediate holding company which would in turn incorporate a local acquisition vehicle. The local acquisition vehicle would be financed with a mixture of equity and loans by the intermediate entity which would also be financed by a mixture of ordinary equity and loans.

The loan is considered as debt for local tax and accounting purposes. Therefore, as a function of the intermediate jurisdiction's domestic law and accounting treatment, the coupon will be treated as deductible as interest on an accruals basis but often taxable as distribution in other countries.

The overall effect of this structure is that the ultimate borrowing entity pays interest, which may be deductible at local level depending on the domestic laws of the relevant territory. Typically, domestic laws will provide for appropriate base erosion protection (eg rules in thin capitalisation, transfer pricing and re-characterisation) designed to ensure that only appropriate levels of interest are deductible. The intermediate entity will receive interest, but will also pay interest and be taxable on a margin commensurate with the activity performed at the intermediate level and in many cases this margin will need to be supported by an appropriate transfer pricing methodology and report. The

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investors will receive income and pay tax in the jurisdiction where they are tax resident based on the local rules and depending on their own tax attributes and the domestic tax rules.

Many jurisdictions will treat this type of instrument as debt in exactly the same manner as the intermediate territory and therefore the instrument will not be a hybrid. The UK would be an example where these instruments are typically treated as a debt and where the investors are individuals they would be taxable on the coupon as interest. Corporate investors within the charge to corporate tax would be treated as having a loan relationship and would be taxable in the normal manner. Some jurisdictions, such as the US may treat the instrument as equity under their domestic legislation, but the only effect of treating the instrument as equity is to delay taxation until cash is received when the coupon is paid, and treated effectively as ordinary income.

Critically, this is quite different from the outcome demonstrated in figure 12. In that example, there is no economic effect as all cash flows are within the same group and therefore the accounting deductions and receipts for the group in aggregate "consolidate out" but with a tax advantage. Within private equity fund structures, there is no equivalent group to the corporate, no ability to consolidate out and no tax advantage, other a small timing difference. The equivalent of "A co" represents external investors and these are taxed as true third party investors. To the extent the external investors are taxable and receive a return representing the underlying coupon, the amounts will, in most if not all cases, be taxed as ordinary income.

It is accepted that this structure may lead to a timing difference as investors will not be taxed until the investment returns are distributed. Typically the maximum deferral is between two and four years depending on when the investment is realised. There will be no long-term deferral at the level of the fund as there is a requirement to remit cash to investors as soon as possible as the fund managers are measured on cash returns.

We believe that the consultation adopts the correct overall approach as the focus on inclusion or non-inclusion appears to be an appropriate policy response and focuses on the relevant "mischief". Based on this interpretation, it is our belief that the typical intermediate holding company structure used by private equity funds should not fall within the proposed rules as the structure is not designed to facilitate tax avoidance. Rather, it exists purely to meet the needs of investors and in particular, investors will normally include the receipt as ordinary income. As a result, there is no hybrid element as defined in table 1

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(Summary of Recommendations) on page 18 of the consultation document on domestic rules.

**Imported Mismatches:**

As explained above, hybrid instruments potentially fall within the basic definition of hybrid financial instrument included in the consultation document, as it is expected to produce an annual tax deduction in the intermediate holding company location but no immediate taxable income in the investors' hands. As these circumstances most often arise in an intermediate holding company structure, in our example the intermediate holding company would fall within the imported mismatch rules as country B. Paragraph 228 states that by Country A or B adopting the "other hybrid mismatch rules" recommended in the consultation document, the effect of imported mismatches would be eliminated and there would be no mismatch to import into Country C. These rules are ordered as:

- Country A implementing controlled foreign company, foreign investment fund or specific targeted anti-avoidance rules to tax on a current basis income of residents accrued offshore;

- Country B preventing reverse hybrid entities (the recommendation on how to tackle imported mismatches is for adoption universally the same set of hybrid rules, though it is also remarked that there will be typically little incentive on the part of the intermediary to introduce such measures);

- Country C adopting a defensive rule to deny the deduction for the payment when certain conditions are satisfied, specifically only to the extent that a primary or secondary rule does not apply in the intermediate territory.

In the case of a private equity fund having a broad investor base, it would be practically challenging to demonstrate which jurisdictions qualify as "Country A" and then specifically whether a domestic dividend exemption applies. In many cases, the basic hybrid mischief to make income "disappear" would not apply because the ultimate investor does not have a dividend exemption system. Examples include most ultimate individual investors and US based investors. This creates a real difficulty, as under the draft proposals the intermediate company would need to switch off the annual tax deduction under the hybrid or the investor countries would need to tax the "dry" income arising in the intermediate territory. In both cases this would apply a tax burden on the investor far in advance of any real cash income or gains.

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The consultation document recognises that the hybrid mismatch rule should exclude the timing of payments and receipts under the laws of different jurisdictions, and therefore this should include imported mismatches. The difficulty is clearly that in these circumstances, one needs to look beyond the position at country B and ascertain how the ultimate recipient is taxed. The simplest method of dealing with the point is to adopt the primary response mentioned above as this will also be consistent with the investor's position. The adoption of a defensive rule where the intermediate country is required to have adopted anti-hybrid rules consistent with the ultimate territory requires all parties to enact the same domestic rules across multiple jurisdictions.

In the event that this does not happen, it will be almost impossible for private equity funds dealing with multiple jurisdictions to administer. In particular, the denial of deduction disadvantages to investors is borne in proportion to their investment, and does not take into account investors where the jurisdiction taxes the same receipt. Therefore it is our view that the defensive rule is inappropriate and we would recommend a much stronger statement on these principles, together with specific examples of circumstances where the defensive rule would not be applicable.

The implementation of an imported mismatch or reverse hybrid rules would require detailed information to be available to the payer in circumstances of imported mismatch and reverse hybrid with respect to the tax treatment in the foreign jurisdiction and the way the payment has been treated by the intermediary. The consultation document acknowledges that there are a number of tax policy and detection challenges presented by the mismatches that point towards a more limited scope when denying the deduction for the payer. For private equity funds, this will be a key difficulty as whilst the payer may be able to ascertain the tax treatment at the intermediary level, they are most unlikely to have any information as to the tax treatment of the underlying investors.

Some information may be available to the private equity fund but not the entirety as some investors will be funds of funds and therefore the available information as to the investor will be restricted to this point. Even if the information is available to the private equity manager, it is unlikely to provide this to the payer as the details will be confidential. Therefore as a minimum, it would be essential for the final document to expand on the circumstances where a deduction could be denied. Some funds will be open-ended or listed and in these circumstances the difficulties indicated above will be exacerbated as clearly it will be almost impossible to obtain information around a constantly changing investor base.

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## Hybrid Instruments:

The rules on hybrid instruments could also impact private equity funds as the amounts paid out of the intermediate entity will also fall within the regime on hybrid instruments.

This would require that:

(i) The jurisdiction of the payer should deny a deduction for any payment made using a hybrid financial instrument, to the extent that the payee/investor does not include the receipt as ordinary income under the laws of any jurisdiction.

(ii) Jurisdictions should require a payee/investor to include any payment under a hybrid financial instrument as ordinary income to the extent the payer is entitled to claim a deduction for such a payment or equivalent tax relief and the payers jurisdiction does not apply a hybrid mismatch rule.

(iii) A dividend deduction should not be granted under domestic law to the extent the amount is deductible so that in these situations no mismatch will arise.

As mentioned above, the overall policy intent is appropriate, but the considerations here are similar to those already raised in relation to imported mismatches. To the extent that a hybrid instrument used by a private equity fund falls within the rules (which we believe should be the exception), we do not believe the appropriate policy response should be to deny a deduction for the payer again for the reasons set out above. In particular:

(i) It will be impossible for the payer to know whether particular investors are not required to include the payment as ordinary income, and therefore will not be in a position to calculate the appropriate disallowance.

(ii) The effect of disallowing the deduction is to spread the cost across the entire investor base, most of the taxable investors will already be required to include the receipt in their taxable income as ordinary income. Therefore the effect of such a rule will be to disadvantage "good investors".

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Private equity is quite different from other taxpayers using hybrid instruments where the payer and recipient are closely connected and the amounts "consolidate out". In private equity the investors are spread across the globe and it is simply impossible for the payer to understand each investor's tax position. Therefore we believe the only realistic answer, where there is a fund consisting of diverse investors, would be for the source country to adopt the "defensive rule" and provide that the investor's jurisdiction has to provide rules requiring the amount is included as income. As we have commented, this would be extremely difficult in practice to identify, prove and communicate to each investment jurisdiction. It would therefore be a disproportionate and disruptive measure.

## Hybrid Entities

It is unusual for European private equity funds to use a so-called hybrid entity but such entities are sometimes used as a pooling vehicle or fund vehicle particularly in the US. These entities are usually not set up to benefit from mismatches, but are hybrid due to the diversity of investors in different jurisdictions and the diversity of jurisdictions these vehicles invest in. Such an arrangement is not based on aggressive tax planning, but merely the result of different rules in different jurisdictions. These pooled vehicles rarely result in 'double non-taxation'. Their goal is to make it possible for different investors to pool their investments without creating an additional layer of tax, i.e. tax neutrality.

For example, it is common for the Collective Investment Vehicle (CIV) to be structured as a partnership but if it is investing in the United States for example, the vehicle will elect corporate treatment for US domestic tax purposes. The effect of this hybrid is twofold. Firstly, investors resident in jurisdictions that have an income tax convention with the United States can maintain the same treaty benefits the investor would have obtained if the investor had made the investment directly due to the fiscal transparency rules commonly applied in most income tax conventions. Secondly, if the investment generates income subject to net income taxation, the choice to make the vehicle non-transparent for US domestic tax purposes means that the vehicle, rather than the investors, will be subject to US net income taxation and the accompanying filing and reporting burdens. This avoids having the numerous investors, often hundreds and sometimes thousands, being required to file tax returns in the United States. It does not reduce the tax burden however.

Taking into account their diverse ownership and structure, these pooled investment vehicles may become innocent victims of anti-treaty shopping and

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anti-hybrid rules. For example, if a fund has 200 investors from 10 different countries and ten US investors use a hybrid vehicle for their investment in the fund, it could trigger the application of rules based on the Action 2 recommendations. Even though the other investors might be taxed on their investment income from the CIV or may be exempt under local law, the recommended imported mismatch rules could allow all of the jurisdictions involved in making deductible payments through the CIV to deny deductibility for the entirety of their respective payments. Potentially, the sum of these disallowed deductions could be many times greater than any income that is not included as a result of the hybrid. In such circumstances, we believe that any hybrid mismatch rules should only apply on a look-through basis to each investor (rather than tarring all of the CIV's investors with the same brush) and in any case, should not apply to unrelated parties.

**Definitions and other matters**

Bottom Up vs Top Down

The top down approach is based on the assumption that every hybrid result is "bad" and the legislation should be drafted on this premise. We hope that our commentary above demonstrates that in private equity, hybrids are not "bad" but are simply part of a commercial structure required to meet the needs of a diverse group of investors. A regime based on including all hybrids and then providing carve outs or exceptions is likely to be both practically difficult to implement and also increase the level of uncertainty to an unacceptable degree to facilitate investment. We strongly urge a more limited bottom up approach to the anti-hybrid rule which can be more targeted and is less likely to impact commercial activity.

Related parties

In addition, we would suggest that there is a much clearer separation between anti-hybrid measures applicable to instruments held by related parties and all other circumstances. The principle of applying the same rules to persons acting in concert and to unrelated parties entering into structured arrangements, and then carving out the issuer of a widely-held instrument creates a multitude of implementation, information and technical concerns. Our recommendation is to treat collective investment arrangements, such as private equity and other forms of pooled investment as a separate category in order to take account of their specific facts and circumstances and the wide variety of investors by type, origin and tax status.

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We can appreciate that entities that are consolidated for financial accounting purposes represent members of the same control group, and therefore as a policy matter must be within the rules.

The term "related party" (paragraph 128) includes companies, funds and other entities as well as arrangements that would generally be expected to take into account the position of their non-portfolio investors (i.e. 10% or greater) when entering into their arrangements with those investors. The 10% threshold is too low given the complexity and risks of double taxation inherent in these rules. Therefore, we suggest that the rules should not apply to unrelated parties and the definition of related party should be based on an ownership test of at least 50%. In the absence of central control, a taxpayer who makes a payment to a 10% investor would not be in a position to obtain information on the tax treatment in order to comply with the rules on imported mismatches or reverse hybrids.

The related party test also includes relationships described as "acting in concert" - parties that have a material interest in engineering a particular tax outcome and there are coordination mechanisms in place that allow them to undertake collective action. This includes shareholders or voting agreements, joint ventures and private equity funds under the control of a common manager. The consultation makes the assumption that all raise relationship issues that are similar to those presented by related parties under common control and should therefore be treated in a similar manner. We dispute the contention that the payer, intermediary and investor are truly all members of the same control group and should therefore be treated in a similar manner.

Unlike a conventional corporate group, it is not a simple matter for any one party to determine the other parties' tax treatment of the same payment. Without action, we would suggest that such as rule will almost inevitably deny a deduction for the payment in the payer jurisdiction in circumstances where a substantial proportion of ultimate investors are taxable. The intermediate entity described above is not a hybrid arrangement (taking the timing position as a separate question) but more a commercial necessity to pool and administer investment funds.

Therefore, we would recommend that the final document adopts a much narrower definition of "related party". Indeed given that private equity funds do not use hybrids to reduce the tax due, but simply to ensure cash receipts and tax payments are matched, the better answer would be to exclude widely-held private equity funds from the definition of related party.

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## Widely held and traded instruments

Similar considerations apply in relation "widely held" instruments and traded instruments discussed at paragraphs 147 to 157 of the consultation document in relation to domestic rules. In relation to the issuers of widely held instruments, the consultation document suggests that in most circumstances, these should be outside the rules as it will not be "practical to expect the issuer to collect the necessary information from numerous holders and make the necessary tax calculations to comply with the hybrid mismatch rule@ as stated in paragraph 148.

The consultation document suggests that the holders of widely-held instruments will not suffer the same constraints as they will be in a better position to obtain the information presumably on the basis the payment is received from one entity and the holder has full visibility of the receipt and their own tax treatment. However, the consultation document suggests at paragraph 152 that whilst the burden would be less, imposing the hybrid mismatch rule on holders would result in the "imposition of compliance mechanisms for both holder and issuer as there would need to be a mechanism to communicate information to the holder in relation to the tax treatment of the issuer and the holder would most likely need to obtain further tax advice on the differences between foreign and domestic law". Given the costs and resources required, the consultation document suggests that this approach might be unacceptable.

This is precisely the point in relation to private equity, as the investors in private equity funds will typically consist of numerous dispersed investors. The position is very similar to investors in a widely held instrument and therefore private equity funds with a wide investor base should be treated in a similar manner.

Paragraph 153 deals with traded instruments, where the position is exacerbated as the issuer no longer has control over the identity of the new holder and may not be in a position to obtain the information. Again, the consultation document indicates that the new holder should be in a better position to determine the position and protect themselves from the application of the hybrid mismatch rule, but points to some of the constraints where the issuer does maintain a prospectus or other information type document. The consultation document suggests that for these reasons, traded instruments should be outside the hybrid rules unless they are part of a structured arrangement intended to avoid such rules. Private equity funds syndicate investments in a similar manner. Consequently, our recommendation is that such syndicated debt [traded on an

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exchange] should also be outside the rules, unless it is part of a structured finance arrangement.

## Administration

The comments above point to some of the issues for private equity in administering these arrangements. The need to identify whether an instrument is a hybrid and then inform all investors is itself costly, but surmountable, particularly if only instruments and structures which give rise to an absolute tax advantage are within the rules. However, it is critical that to the extent hybrids are caught that any disallowance is at the level of investors as they will be in the best position to deal with the administration required. It is essential the rules are implemented consistently and that the associated costs are minimised such that it does not impact the wider business community. If the consequence is that different countries implement the rules differently and there is no consistency, this would represent a major setback for business.

## Purpose test

Objective mechanical tests may offer apparent certainty, but do not take into account situations that are not abusive but just happen to fall within the definition. To ensure that global commerce operates without distortion resulting from income tax considerations, such unintended applications of mechanical tests – which would be costly and counter-productive – must be avoided.

We believe a structured purpose test is essential to reduce the likelihood of unintended consequences and limit the collateral damage that could arise if the implementation of these proposals affects innocent parties or gives rise to double taxation. A structured purpose test would provide a subjective test of a taxpayer's motive, i.e. whether the intent of a particular hybrid entity or transaction test is tax avoidance. Such a test would require a consistent standard, such as 'principal intent' or 'substantial purpose,' which could be applied to all situations. In order to ensure consistency, a structured purpose test should also include certain presumptions based on specified hallmarks of potential abuse.

A purpose test seems particularly important in the context of transactions between unrelated parties, where the potential for abuse is generally much lower. Such unrelated transactions that might trigger application of mechanical hybrid mismatch rules should be subject to a purpose test in order to ensure that mechanical rules not be applied inappropriately to transactions that lack the requisite tax avoidance motive.

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Even in a related-party context, a structured purpose test would be helpful in ensuring that routine intercompany transactions reflecting normal business practices not be penalized simply because a hybrid transfer or entity happens to be involved. Alternatively, rules implementing the Action 2 proposals could include a 'business purpose' exception for related-party transactions, where the taxpayer has the burden of proof to show that such transactions have no tax avoidance motive.

**Conclusion;**

It is clear from the complexity of the issues contained both in the consultation documents and our comments above that the scale of the issues in Action 2 is challenging. The objective of seeking a coordinated response across multiple jurisdictions is, we believe essential. Nevertheless, such a coordinated approach will be very difficult to achieve in practice because individual jurisdictions have developed their tax laws to reflect a policy decision, for example, to allow a tax deduction in order to attract inward investment, which is their prerogative to do so.

This debate on Action 2 can be distinguished from the BEPs work-stream on issues such as permanent establishment and profit attribution. In that domain, where one entity has a permanent establishment in another jurisdiction, both jurisdictions want to exercise taxing rights and look to the OECD to give guidance on a fair and consistent approach. In relation to hybrids however, the OECD seems to be encouraging jurisdictions to tax instruments in certain circumstances even though those jurisdictions have made a policy decision not to do so. Failure to implement this approach in a fully uniform manner will mean that it will not work as anticipated.

Therefore, we feel it is essential that sufficient time is dedicated to allow for modifications to the design of the recommendations. In addition to adequate time, appropriate transitional arrangements should be put in place in order to deliver smooth implementation of any new rules. Such safeguards will ensure that they are focused only on abusive outcomes, do not result in outcomes which give rise to double taxation and importantly, do not hamper the financing of companies, most notably small start-ups.

Private equity funds use instruments which are treated as debt in the payer jurisdiction and equity in the recipient jurisdiction, but they generally give rise only to short-term timing differences. We do not believe that such short term timing differences should be caught by the proposed rules. Indeed, it appears

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that the consultation document is not trying to catch timing differences, but the position needs to be clarified. If timing differences are caught, there would need to be further complicated provisions to avoid double taxation for the investor (ie. to avoid tax on accruals and tax again on receipt) or penal asymmetry (ie. tax for the investor with no deduction for the payer).

The proposals require the payer and/or the payee to have detailed knowledge of the other's tax treatment, and that is very difficult in the context of a private equity fund. There is consistency here with the similar points in the submission from the Public Affairs Executive of the European Private Equity and Venture Capital industry on Action 2 – Preventing Treaty Abuse. Just as it is difficult to establish with certainty the treaty status of investors in a private equity fund, it is difficult to establish the precise nature and timing of investors' domestic tax treatment on a particular flow of income.

**Summary of EVCA Recommendations:**

1. We believe the action designed to neutralize the tax effects of hybrids is an appropriate policy response.

2. We agree with the consultation that timing differences should not result in an instrument being treated as a hybrid, as that would then require the treatment to be reversed as the investor was taxed. This would be complex and undesirable.

3. In the event that an instrument is caught by the hybrid rules, the primary response should be inclusion at the investor level. This is consistent with the principle underlying a private equity fund that the investors should take responsibility for tax on investment income and gains. In addition, a disallowance at the level of the portfolio company would result in the disallowance being borne by all investors and not just those benefitting from the hybrid treatment.

4. In relation to whether the definition of hybrid should be 'top down' and effectively treat all hybrids as bad with certain carve outs, or focused on specific circumstances, the 'bottom up' approach, our clear preference is for the bottom up approach: it is more focused and less likely to lead to inadvertent commercial issues harmful to investment and the overall economy.

5. The rules should only apply to related parties and the related party definition should be based on 50% ownership. A test based on a lower level of

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ownership will mean that taxpayers are not in a position to obtain information on the recipient's tax treatment and comply.

6. The suggestion that investors and private equity firms represent "concert parties" is inappropriate. The investors in a private equity firm are similar to other public shareholders, indeed in many cases they will be the same investors who are also shareholders across the listed markets and should be treated in a similar manner. This is supported by the discussion in the document in relation to widely held instruments and traded securities.

7. Many countries already have extensive rules in relation to interest deductibility and therefore further limitations based on the use of hybrids seems "overkill" and will be harmful to economic activity. It is also important that any limitations are coordinated and consistent with BEPs Actions 3 & 4 on interest deductibility.

8. These rules will ultimately impose additional costs on business, for the payer and ultimate recipient, if only to ensure compliance with their obligations. Therefore it is incumbent on governments to ensure action is focused and costs are minimised otherwise this will impact the wider economy.

9. The rules should include a purpose test to ensure the proposals do not inadvertently catch innocent transactions, reduce the compliance burden and ensure the rules do not impede international trade.

10. The rules for hybrid entities should be clear and apply on a look-through basis to each investor and in all cases should not apply to unrelated parties.

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## Contact

Thank you in advance for taking our comments into account as part of the consultation process. We would be more than happy to further discuss any of the comments made in this paper.

For further information, please contact Danny O' Connell at the European Private Equity & Venture Capital Association (EVCA).

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FIDAL

***BEPS action 2: draft comments***

Further to the Committee on Fiscal Affairs' circulation of two draft documents relating to Action 2 of the BEPS action plan (hereinafter the "**Drafts**"), we are pleased to provide you with the following comments which pertain only to the Draft relating to domestic measures (hereinafter the **"Domestic Laws" Draft**).

## I. General observations

We share the OECD's observation that hybrid mismatches can result in financial advantages that are not actually justified and that should therefore be eliminated to the extent possible.

That said, this phenomenon is, in our view, a marginal one. Indeed, before deciding to take advantage of a hybrid mismatch, a multinational group must first make sure:

- That such a mismatch actually exists, taking into account the characteristics of the domestic laws in question and the way they are construed by the Administration's departments and the courts;

- That the mismatch cannot be called into question based on a general or specific anti-abuse measure;

- That making use of the mismatch will not harm its reputation.

To our knowledge, it is therefore rare for an MNE to act on such schemes and for all the stakeholders in the decision to come out in favor of setting up a hybrid mismatch arrangement.

Given this, it seems to us that the OECD's recommendations should be proportionate to the actual problem at hand and disrupt as little as possible the transparency/clarity of tax law and the intrinsic coherence of tax systems. We are not convinced that the **Drafts** meet those objectives.

It seems to us that the corrections to be made to domestic tax provisions should, above all, target those that are the main source of hybrid mismatches. Otherwise, we might end up with non-coordinated measures whose drawbacks (incomprehension by businesses, loss of attractiveness of certain countries while others maintain schemes that are reprehensible according to the "BEPS 2" action, creation of indirect discriminatory measures that could be invalidated on treaty or Community law grounds, etc.) might greatly outweigh the benefits (elimination of the hybrid mismatch).

Moreover, we think it would be more efficient and fairer for the OECD to identify some or all of the hybrid-mismatch generating measures that need to be modified in order to dismantle the mismatches, somewhat like the approach implemented through the Code of Conduct under the auspices of the EU authorities.

## II . Specific comments

### 2.1 Hybrid financial instruments/transfers (nos. 59 to 162 of the **"Domestic Laws" Draft**)

It seems to us that the measures to be adopted should be adapted to the nature of the instrument. For example:

- A debt instrument under which the income is not taxed at the level of the creditor and the expense is deducted by the borrower should, in our opinion, give rise to a modification of the domestic provision in the country of the creditor, so that said provision is effectively limited to cases of economic double taxation;

- Failing which, the domestic provision of the country of source of the income should be modified so that the payment is subjected to a withholding tax.[1]

In our opinion, there are several drawbacks to correcting the mismatch by prohibiting deduction from the borrower's result:

- In cases where the borrower is not fully owned by the creditor (or its group), non-deduction also penalizes the borrower's shareholders who do not benefit, economically, from the exemption of the income;

- Where the debt instrument is freely negotiable, the borrower will not be informed of a transfer of the instrument to a creditor who benefits from an exemption of the income and may therefore end up being penalized by a non-deductibility measure, whereas it does not derive any benefit (even indirect) from the hybrid mismatch;

- The anti-abuse measures aimed at countering interest deductions are based, in principle, on the situation of the borrower, not on that of the lender.

It seems to us that it is inconsistent with the coherence of the tax system to penalize the borrower for a supposedly abnormal advantage procured to the creditor.

If it were confirmed that the principal measure for eliminating the mismatch is non-deduction from the borrower's income, it would then be appropriate, in our opinion, to at least:

- Limit the measure to cases where there is a strong legal tie of dependency between the borrower and the creditor (the borrower's capital is not held by any independent shareholders),

[1] In this regard, it seems odd to us that the document does not make any reference to how the creditor is taxed in the country of source of the income.

- Not apply this measure if the income is taxed in the creditor's country, even at a reduced tax rate (cf. **"Domestic Laws" Draft,** no. 95),

- Not apply this measure to negotiable (i.e. freely transferrable) instruments, except in case of abuse,

- Not apply this measure if the creditor benefits from an exemption tied to its status (cf. **"Domestic Laws" Draft,** no. 100, which in our opinion contradicts no. 23).

2.2 Hybrid entity payments and reverse hybrids (cf. **"Domestic Laws" Draft**, nos. 163 to 236)

It seems to us more in line with the coherence of the tax system that, in the event of a double deduction of the same expense generating an undue advantage for the group, the deduction to be disallowed should be the one in the investor's country.

A law prohibiting the deduction of an interest expense solely because that deduction has already been carried out in the investor's country would raise numerous difficulties:

- Unequal treatment between domestic investors and non-resident investors,

- The minority shareholders of borrowing companies would be penalized,

- Lack of transparency/clarity of the tax law of the subsidiary's country, whereas the investor's country is generally the one causing the mismatch by (i) allowing the creation of entities that have no substance or economic role or (ii) leaving investors with a large choice in determining the tax regime of foreign entities.

If the tax law of the subsidiary's country had to be modified, we think it would be more appropriate that this be in relation to the withholding tax applied to the income received by the creditor.

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By email to: aggressivetaxplanning@oecd.org

1 May 2014

Dear Sir/Madam

**Comments on OECD discussion draft "BEPS action 2: neutralise the effects of hybrid mismatch arrangements"**

We write with some comments from our London practice about the hybrid mismatch discussion draft (recommendations for domestic law) released in March 2014. Many of the comments will we expect be familiar from what has been said by us in consultation meetings.

We much appreciate the opportunity that has been given to us to participate in the consultation.

1. The discussion draft is hugely impressive but also hugely ambitious. It results in complexity, possible administrative and compliance burdens and a risk that more arrangements are captured than deserve to be captured. It seems to us that at this early stage in the BEPS process it is important to ensure that proposals are settled that will readily gain acceptance and can easily be implemented without giving rise to unfairness.

2. This involves, to our minds, dealing primarily with cross border arrangements within corporate groups (or at least among appropriately defined related parties). Some of the consultation discussion has focussed on aspects of non-group "structured" arrangements

which can go to the fringes of the BEPS project, at least in the eyes of many observers. For example, the treatment of regulatory capital instruments which are issued from a jurisdiction that gives a deduction for AT1 and which are held narrowly by exempt institutions in another country where, had those institutions been taxpayers, a hybrid mismatch may have arisen (see on this paragraphs 99-102 of the discussion draft) is something that we would regard as distant from the BEPS project. At least on a "top down" approach, however, it could be affected by the proposals.

3. The "structured" concept for non-group or non-related party cases seems designed for tax avoidance situations and we believe it should be possible to frame a test (as a fundamentally objective avoidance test, which could take into account factors such as those in paragraph 131 of the discussion draft) that recognises that point so that there is a workable, "bottom up" approach, which need not give rise to some of the debate about matters such as what is "widely held", or the basis on which many third party repo or stock loan situations should be excluded.

4. We also believe that there should be recognition that some intra-group or related party cases may not be offensive even if a form of hybrid mismatch can be identified. In other words there should be exceptions and an opportunity (perhaps because an unacceptable mismatch presumption can be rebutted) to make out an appropriate case that the proposed rules should not apply. For example:

(a) a planning mismatch may, it seems to us, be justified for regulatory capital push down situations in circumstances where capital is provided from a home jurisdiction which does not give relief for regulatory capital to a subsidiary in a jurisdiction which does, where the position of local competitors (and a level playing field) needs to be taken into account;

(b) double taxation situations can arise across borders (e.g. where non-deductible outgoings are matched by taxable receipts) and planning to work around them should not necessarily be regarded as unacceptable. Those situations could increase in a post-BEPS actions environment, including as a result of the hybrid proposals themselves (e.g. as they interact with CFC rules);

(c) there is a case that local tax policies in particular countries should not be overridden by the BEPS proposals.

This approach could relieve some of the assumed pressure on the 'related party', 'acting in concert' and 'non-standard investment vehicle' definitions. We are aware for example of concerns over the 10% threshold for the related party definition and the approach to 'acting in concert'.

5. Hybrid mismatch planning techniques are often difficult to trace through transactions and entities, and can involve combinations or overlap. (For example, hybrid financial instruments may be combined with hybrid entities; and hybrid mismatches may be combined

with other forms of planning.) If a rule is to be cast widely in order to capture them as far as possible this also to our minds strengthens the case for a regime that involves greater flexibility than the core proposals contemplate. As we understand things those proposals do not presently include any discretions, any avoidance test, any exceptions, or any form of just and reasonable (or appropriate comparator) limitation to the extent of a counteraction. The risk of unintended consequences and uncertainty is severe, especially in the early stages as countries introduce domestic rules at different times and in different detailed ways.

6. The planning sought through hybrid mismatch arrangements can often be achieved through other techniques, with which other aspects of the BEPS project may be concerned. For example they may involve:

(a) residence mismatches (e.g. as an alternative to a reverse hybrid);

(b) CFC planning;

(c) transfer pricing (including mismatches where one jurisdiction gives relief for a deemed expense but the other relevant jurisdiction does not identify deemed income);

(d) notional interest deduction regimes,

as well as simple planning around tax rates and profiles (e.g. injecting debt rather than equity from a low tax rate jurisdiction to a high tax rate jurisdiction).

The relevant mix of techniques will vary from country to country and there is an obvious need for the hybrid mismatch proposals to be aligned with those developed in other areas and seen appropriately in context. Addressing hybrids before other forms of planning may be seen as having an unbalanced impact on particular countries or companies based in them. There is also a risk to our minds that dealing with hybrid mismatch proposals first may involve applying them more extensively than may ultimately be necessary.

7. The proposed primary and secondary responses seem somewhat inconsistent, when various different arrangements and situations are considered that are designed to achieve the same planning objectives. For example, to take the fundamental case where a company headquartered in an investor (home) jurisdiction seeks to fund a company in an operating (source) jurisdiction in such a way that there is a deduction in the source jurisdiction but no income pick up in the home jurisdiction, the planning could be based on:

(a) a hybrid financial instrument or transfer;

(b) use of a hybrid entity for D/NI (e.g. hybrid entity in source jurisdiction borrows from the parent home jurisdiction, where the hybrid is disregarded);

(c) a D/NI reverse hybrid (transparent in the source jurisdiction, where it lends to the operating entity, but opaque in the home country);

(d) an imported mismatch (e.g. a reverse hybrid in an intermediate country lends to a company in a third country, which is the source country);

(e) a D/D hybrid entity as in a UK outbound "Tower" structure ( e.g. a structure of the type outlined in the Financial Times on 25 November 2013), where one of the deductions offsets income arising in the investor jurisdiction;

(f) planning of the type indicated at 6 above.

It might be expected that since all of the techniques are directed at the same planning objective the same fundamental response would be applied to them. Instead the proposals are likely to produce their own somewhat mechanical mismatches. It might be thought more natural to start with identification of the jurisdiction the tax base of which is likelier to be regarded as eroded (perhaps by reference to a comparator).

8. The D/NI mismatch concept is complicated by reference to the extent to which "NI" may extend beyond returns that are simply tax free. For example:

(a) it is said that timing/deferral mismatches are not caught. But deferral can in some structures be long term and it is not unusual to find that other events occur before realisation of a return. Change of law may also be relevant in a deferral environment;

(b) is taxing the return at a lower rate than the rate at which ordinary income is taxed something that counts as "NI"? For example, certain returns regarded as having a dividend or distribution nature may be taxed at lower rates (e.g. at capital gains rates) than the rates applicable to interest;

(c) it does not strike us as straightforward to determine which *measurement* differences should be caught. For example, deductions in a source jurisdiction for funding pushed down to that jurisdiction may in some structures be matched (ultimately) by a taxable return in an investor jurisdiction but only on the basis of the overall investment profits regarded as arising in the investor jurisdiction.

These areas may also overlap (see below).

9. A related point is that if a failure to tax income (or tax it in principle) in the investor jurisdiction leads to a denial of relief in the borrower jurisdiction the denial of relief may easily be quite disproportionate in its consequences. (This is especially obvious in the case of an exempt institution investor: see 2 above.)

10. The treatment of investment funds seems to us to be a difficult area, which may need to be explored in more detail for intended outcomes. One situation to analyse might be a typical private equity fund investment structure. On this:

(a) a private equity fund investor would we expect typically (as a limited partner in a fund partnership) be included as a related party of an acquired group and the

companies through which the fund invests into the acquired group by virtue of the common management role of the general partner or manager of the fund;

(b) the identification of the hybrid mismatch, if any, may presumably involve a look through to the actual tax treatment or notional tax treatment of particular limited partner investors (corporates, individuals, exempt institutions, etc.) in the different countries in which they are based. This may in turn involve looking through further fund investors;

(c) income might arise on a form of hybrid instrument treated as equity in one or more investor jurisdictions, such as a Luxembourg PEC or C-PEC, which produces (for certain investors) the (possibly overlapping) features of a return on the instrument indicated in paragraph 8 above. Hybrid entities may also be involved;

(d) the hybrid instrument may match with debt (possibly held by another Luxembourg entity) that is injected to, or to a local holding company of, an acquired group, where interest is relieved as it accrues. This may (depending perhaps on (c) above) give rise to an imported mismatch. It is also possible however that the interest will be relieved only in part (e.g. thin capitalisation or other domestic rules will often restrict it).

11. Transitional arrangements need to be addressed, as may the treatment of corporate restructurings implemented as a response to the proposals.

12. The interaction with EU law will fall to be considered, as well as the interaction with double tax treaties.

Yours faithfully

Freshfields Bruckhaus Deringer LLP

HCAT
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May 1, 2014

**TO: Achim Pross, Head, International Co-operation and Tax Administration Division, OECD/CTPA - Email: aggressivetaxplanning@oecd.org.**

**AND TO: Marlies de Ruiter, Head, Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA - Email: taxtreaties@oecd.org.**

**OECD Paris**

**Re: Comments on Two OECD Public Discussion Drafts Regarding BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements 19 March 2014 – 2 May 2014 (Recommendations for Domestic Laws) AND (Treaty Issues)**

**Background**

On March 19, 2014, the OECD published draft proposals for tightening the taxation relating to hybrid mismatch arrangements of multinational concerns

Some multinational concerns pay little or no tax anywhere by exploiting differences of approach in different countries regarding financial instruments, entities and group taxation.

As a result, expenses in one country may be deductible more than once or not taxed as income anywhere else.

We are an Israeli accountancy firm with much experience of international taxation of multinational firms.

**Comments:**

We believe the proposals presented in the Public Discussion Drafts will prove unworkable because they are complex, bureaucratic and will create uncertainty for many years for multinational concerns.

There are primary rules if two countries adopt the same OECD recommendation, and secondary/defensive rules if they don't.

Issues arising

1. The proposals are complex and subjective or judgmental in many respects.
2. Tax administrations may not know which hybrid technique, if any, has been adopted and how it works.
3. If there are group counterparties in several countries, what happens? This is only answered in cases where the hybrid technique involves more than two countries.


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4. Won't different countries choose whichever is better for them, primary or defensive? There is no system for coordination and resolving differences of approach. That will cause double or multiple taxation.

Until the international banking system is better capitalized and fully recovered from recent credit crunch and sovereign debt crises, multinational concerns should be encouraged to finance themselves, not be penalized.

**Our Alternative Proposals:**

We propose simpler and more certain tax rules for addressing hybrid mismatches, as follows:

1. Allow expense deductions if it is proven the payments concerned are subject to tax elsewhere within, say, 2 years before or after the tax year concerned.
2. Such proof may take the form of tax assessments and/or parent company auditor confirmations.
3. In addition, a modest withholding tax and/or VAT may be imposed in the payor country, say 5% - 10%. Since a withholding tax is a tax on a gross income, the effective tax rate on net income (after expenses) is usually higher.
4. Double tax relief should be available in the recipient country for such tax applying the credit or exemption method.
5. Such rules are only needed for payments between related parties.
6. Such rules should be incorporated in both domestic laws and tax treaties via the OECD model convention.
7. Competent authority and arbitration provisions in tax treaties should be strengthened to ensure differences of approach are resolved within a prescribed period, say 2 years.
8. There should be a system of international tax tribunals for hybrid mismatches, BEPS and other matters.

We would be happy to answer any questions arising.

Yours Truly,

Leon Harris, CPA (Israel), FCA(UK)

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# Submission on the OECD Discussion Draft on neutralising the effects of hybrid mismatch arrangements

2 May 2014

Mr. Achim Pross
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2 May 2014

**OECD public discussion drafts on neutralising the effects of hybrid mismatch arrangements (BEPS Action 2)**

Dear Mr. Pross,

Ibec represents the interests of Irish business including indigenous and multinational enterprises and SMEs, spanning all sectors of the Irish economy. Ibec and its sector associations work with government and policy makers at national and international level to shape business conditions and drive economic growth. Ibec is also a member of BIAC and Business Europe and broadly supports the views communicated by these partners in their contributions to the OECD on BEPS.

Ibec wishes to acknowledge the extensive and detailed analyses by the OECD contained in the two discussion papers on 'neutralising the effects of hybrid mismatch arrangements' (BEPS Action 2). Ibec is grateful for and values the opportunity provided by the OECD to outline the views of its members on this and other discussion drafts.

Ibec supports the Action 2 objective of addressing hybrid instrument and hybrid entity mismatches. As highlighted in its previous submissions to the OECD on other BEPS Actions, Ibec also attaches a high priority in new tax regulation to measures which provide greater clarity for business (and for tax administrations) and minimise administrative and costs burdens. New tax rules should not generate uncertainty in relation to their scope and application, or give rise to inconsistencies in interpretation/application of measures by different jurisdictions which could inadvertently result in double taxation or create additional administrative and costs burdens for business. It is also of critical importance that new rules developed to address mismatches do not inadvertently impact negatively on genuine international business activities. This is particularly important for open trading economies like Ireland with smaller domestic markets where cross-border trade and investment are key to economic growth and employment.

Ibec suggests that the following issues should be taken into consideration in ongoing discussions on Action 2:

- Ibec welcomes the emphasis placed in the discussion draft on the need for coordinated and consistent application of hybrid rules internationally. But to support coordinated application and promote greater certainty and clarity for business (and tax administrations) consideration should be given to the introduction of processes aimed at monitoring how new hybrid regulation is implemented by individual countries. The implementation of new hybrid rules should also be monitored to ensure that a sufficient number of countries adopt

and implement regulation within a similar timeframe to support a functioning and fair international framework (otherwise to avoid creating increased potential for regulatory mismatch and confusion, any implementation should be deferred until sufficient numbers of jurisdictions implement the new rules).

- The discussion draft highlights the close links between proposals on hybrids and continuing work on other BEPS Actions in OECD Working Parties. The outcome of ongoing deliberations on linked BEPS Actions in areas including interest expense deduction limitations (Action 4), controlled foreign company (CFC) rules (Action 3), and Treaty Shopping (Action 6) are likely to have a significant crossover with, and impact on, new hybrid rules. It is therefore critical that the conclusions reached by Working Parties on other key BEPS Actions are fully reviewed and taken into account before final decisions are reached on new hybrid rules. Indeed, the provisions agreed in other BEPS Actions (especially with regard to clearly-defined CFC rules applied internationally) may generate strong protection against BEPS from hybrid arrangements and other sources of tax mismatches; rules on hybrids could then be designed to target any specific areas or issues not already addressed in other BEPS Actions (see also below).

- Ibec considers that CFC rules protect against BEPS and with regard to CFC rules operating to tax income, hybrid rules should not be applicable.

- One of the core aims of the BEPS process is to address instances where income is not taxed in any jurisdiction. If cross-border transactions are subject to withholding tax in a jurisdiction, hybrid rules should not be applied.

- New hybrid rules should be easy for taxpayers to apply and easy for tax authorities to administer. The definition of a hybrid instrument and the scope of instruments covered by the rules in the discussion draft are broad. Ibec suggests that more narrowly defining existing definitions in the discussion draft will reduce the scope for different interpretation which can lead to inconsistent and uncoordinated implementation and uncertainty and confusion for both taxpayers and tax administrations. Without greater clarification of the definitions and rules there is a real risk of double taxation and other unintended consequences which could impact on unrelated business activities.

- The discussion draft acknowledges the considerable complexity inherent in addressing hybrids and suggests that this may be overcome by a more coordinated adoption of the new rules by countries. The draft proposes that countries should be given discretion to define the scope of transactions covered by hybrid instrument rules and in other areas (for example defining the extent to which an item is included in ordinary income). This approach may lead to different interpretations in different jurisdictions of the same core rules, contributing to a more complex and uncertain tax environment. Ibec again suggests that the definitions and proposed rules outlined in the discussion draft should be more tightly defined to reduce the scope for varied interpretation and inconsistent treatment/application in different jurisdictions.

- The discussion draft suggests that the risks associated with mismatches are increased in relation to transactions between related entities. These entities make up a large proportion of cross-border transactions and to avoid negative and unintended consequences, new rules should be defined to ensure that genuine businesses do not need to review whether there is a potential hybrid mismatch risk in each transaction undertaken.

- Access to finance and the ability to raise capital in a cost-efficient manner to fund growth and trade expansion is a key concern for business. This is especially the case for small and medium enterprises (SME's). Provisions that are too wide in scope in applying to debt raising activities in the financial markets and which are complex to administer could create further barriers for SME's in accessing financial markets to fund growth and expansion.

- In its 'overall approach to scope' of the hybrid instrument rules, the draft outlines the respective merits of 'bottom-up' and 'top-down' approaches. To minimise potential administrative burdens for tax administrations and taxpayers, Ibec considers that a bottom-up approach would be preferable and should exclude all transactions except for structured transactions.

- In terms of the proposals for domestic legislation in the discussion draft, taxpayer's deduction or inclusion is related to whether the deduction/inclusion is granted in another jurisdiction. This would mean that taxpayers would need to assess not only how the transaction would be reviewed by the tax administration in their home jurisdiction, but also require an assessment of the likely view of the tax authorities in the second jurisdiction. In practical terms this would add considerable administrative and costs burdens on business.

- The complexity of applying rules on a bilateral basis may be magnified in the case of new rules on imported mismatches where rules are applied in multiple jurisdictions.

- It is critical for Ireland and other EU Member States that the proposed rules should not conflict with core EU regulation governing the free movement of capital to avoid the creation of an inconsistent international tax environment for taxpayers operating across different regions.

- Given the complexity of the measures proposed and the danger of different interpretations of proposals in different states or territories it is essential that effective formal resolution mechanisms are established at an early stage to arbitrate in disputes.

**Concluding remarks**

Ibec is grateful to the OECD for the opportunity provided to outline the views of Ibec members on this detailed and comprehensive draft discussion paper and would be pleased to elaborate on any of the issues raised in this submission.

Ibec very much looks forward to continued engagement with the OECD on this and other BEPS actions and initiatives.

Yours sincerely,

_____

Fergal O'Brien
Head of Policy and Chief Economist

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2nd May 2014

Dear Mr Pross

**OECD DISCUSSION DRAFT ON BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS**

The International Banking Federation (IBFed) is the representative body for national and international banking federations from leading financial nations around the world. This worldwide reach enables the IBFed to function as the key international forum for considering legislative, regulatory and other issues of interest to the banking industry and its customers.

The IBFed understands the importance of the Base Erosion and Profit Shifting (BEPS) project, and the OECD's expectation that the final outcome will deliver fair, certain, predictable, sustainable and principled rules that taxpayers can easily apply and tax authorities can easily administer.

The IBFed would like to express its gratitude for this opportunity to comment on the OECD Discussion Draft on BEPS Action Item 2, Addressing Hybrid Mismatch Arrangements issued on March 19, 2014. We respectfully submit the following comments on this issue for your consideration.

**Regulatory Capital**

Bank capital is currently subject to extensive and developing regulatory rules designed to ensure the stability of banks and the wider financial system. This includes minimum capital requirements under Basel III which are being given effect by domestic legislation.

Central to the reforms has been the objective of ensuring a bank has sufficient regulatory capital to protect creditors in the event of a bank becoming distressed or failing. A hierarchy

of regulatory capital instruments, including Additional Tier 1, capital has been developed to achieve orderly recovery or resolution of such banks. Such instruments have both equity and debt characteristics and many countries have determined or are determining which treatment should follow for tax purposes. Accordingly certain forms of regulatory capital held internationally could be considered hybrids for the purposes of Action 2. We believe it is critical to ensure that Action 2 does not undermine the alternatives that the regulatory regime has designed to ensure that banks are able to raise adequate regulatory capital.

An additional concern with regard to the treatment of regulatory capital as hybrid would be any presumption that all forms of hybrid capital should be subject to increased scrutiny. As hybrid capital instruments will largely be utilised in response to regulatory requirements, we believe that any anti-avoidance measures to target hybrid capital should be limited to specific instruments where there is a justified concern over the use of the instrument. We urge that such instruments issued by regulated banks to meet their regulatory capital requirements be outside of the ambit of Action 2.

Some regulators prefer banking groups to raise capital from the market from one entity and to then appropriately capitalise banking subsidiaries from within the group. Indeed, bank groups may commercially wish to limit the number of times they raise capital in the market and indeed the number of entities within the group which do so. As such special consideration needs to be given to the ability of banks to issue such instruments within a group.

**Capital instruments through a vehicle such as a special purpose company ("SPC")**

We would like to confirm that capital instruments through a vehicle such as a special purpose company ("SPC") located in an offshore financial center may not be subject to the hybrid financial instrument rule. We ask that you confirm this to be the case if the following conditions are met: 1) there is no hybrid mismatch in items included in expenses, and 2) such items are excluded from taxable income between a final fund raiser and a final investor.

For example, assume a funding arrangement where a bank issues a subordinated bond to an SPC located in the Cayman Islands, and this SPC issues a preferred share to investors. Under this arrangement, interest on the subordinated bond paid from the bank, a fund raiser, to the SPC is included in the bank's expenses, while interest received by the SPC is not included in the SPC's taxable income. Note, however, that analysing the arrangement as a whole, the preferred dividend received by the final investor is taxed. Accordingly, there is no hybrid mismatch issue in such an arrangement, and the proposed rules should not apply.

**Application of the proposed rule to the issuer of a widely-held instrument**

It is extremely difficult for banks (or other issuers) to identify investors and confirm tax treatment in the different jurisdictions of such investors with respect to their fund-raising activity in international markets. This is especially true in cases where trades are executed in the secondary market or by global offering. Consequently, the application of the hybrid financial instrument rules on a "Top down" basis may adversely impact international funding markets by shrinking the amount of such activity and therefore reducing overall liquidity. We strongly urge that a "Bottom up" approach be adopted ensuring that Action 2 is targeted at the areas of potential distortion rather than seeking to apply a "Top down" approach.

We hope that you find our comments and concerns constructive. The IBFed remains at your disposal should you have any queries about this letter or require anything further.

Yours sincerely,

Mrs Sally Scutt
Managing Director
IBFed

May 2, 2014

By email

aggresivetaxplanning@oecd.org

Organization for Economic Co-operation and Development (OECD)

**Subject: Comments on the public consultation: Draft BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Recommendations for Domestic Laws)**

IFA Mexican Branch (IFA Grupo Mexicano, A.C.) is pleased to comment on the discussion draft of the above-mentioned subject. Following are our comments.

Paragraph 25 of the OECD discussion draft titled "Recommendations for Domestic Laws", establishes that the hybrid mismatch rules would apply only if a hybrid element exists in the arrangement.

1. In our opinion it is necessary to clarify which are the elements or the hypothesis, that need to be identified as a hybrid element, in order to assess if the taxpayer is in presence of a hybrid mismatch rule, for each category of arrangement: hybrid entities, hybrid financial instruments and reversed hybrid and imported mismatches.

2. We recommend to clearly establish that these rules are only applicable to related parties (included in the rules listed in paragraph 27). Furthermore, it is necessary to be clear that these rules should only be applied to hybrid instruments or arrangements entered into between related parties and provided certain requirements are fulfilled, not necessarily to every hybrid instrument or arrangement. Specially considering that it is recognized in

paragraph 95 of the Draft that certain mismatches are derived not from the hybrid instrument itself but from a particular characteristic of the taxpayer.

3. The definition of related parties as established in the table on page 34 of the report should be revised so that it better reflects economic and business reality rather than taking a purely defensive approach, because as the rule is currently drafted this is clearly its approach (defensive). The 10% threshold is based exclusively on the non-portfolio investor concept.

4. Separating out the acting in concert concept from the threshold will give the approach of the rule a more general scope. Although the rule establishes that the concept of related parties will be re-defined under local legislation, it is important to clearly establish cases of exception to the rule (safe harbor rules), such as situations where the creditor (non-related party of a debtor) of a debt could have certain power over the management of the debtor for operating reasons, which can cause the transaction to automatically be considered to fall under the acting in concert concept, when in reality the purpose of this power was never to receive a benefit.

Point 2 of paragraph 27 provides a series of criteria that should be complied with, in order to ensure the good design of the hybrid mismatch rules. Paragraph 28 specifically clarifies that the rules should target the mismatch rather than focus on establishing in which jurisdiction do the tax benefits arise. Paragraph 32 recommends that the rules should apply automatically, which means that it is not necessary that the tax authorities make the assessment that the rules will apply.

1. Regarding the above, in order to have efficient automatic rules, all the applicable hypothesis needs to be set, so the tax payer could apply the hybrid mismatch rules by itself, if not, such rules could be interpreted and could create space for new tax strategies.

2. In connection with paragraph 30 the rules need to be comprehensive, so it would be recommendable that this document suggests a general framework of rules or a set of minimum elements, that each jurisdiction needs to take in consideration in the preparation of domestic hybrid mismatch rules.

3. Also it is established that the hybrid mismatch rules should be designed for domestic law, however it should also be established that the hybrid mismatch rules should not be applicable in certain particular cases such as, those cases in which the different Countries entering into a Tax Treaty grant a benefit in the Treaty and produce a mismatch. Specifically since it is recognized that the compliance cost should be kept at a minimum.

4. From the public discussion draft it is granted that every hybrid mismatch instrument or arrangement seeks to obtain a tax benefit and reduce a tax burden, however in certain cases the mismatch was not intended, therefore the public discussion draft should contemplate the possibility to demonstrate the above and therefore that it is entitled to the tax benefits or certain guidelines to establish exceptions for the applicability of the hybrid mismatch rules.

5. The proposed solution to the problem involves compliance with a series of points and requirements; however, in practice, this could represent a significant expense and administrative burden for entities to identify and understand concepts such as: non-standard investment vehicles, acting in concert, bottom-up and top-down approach, related persons, ordinary income, etc.

6. Based on the above, this would mean that, at least in our opinion, it would first be necessary to establish clear definitions of the concepts, though even if this were the case, the OECD is clearly not considering that the tax laws of a given country are not the only factor in this analysis. In fact, even though the economic substance may affect the applicable tax treatment (the report at discussion seems to only focus on a merely formalistic approach), legally speaking, the agreements and transactions concluded may have a different nature that is given under civil and commercial laws.

   As an example, from a legal perspective, the distinction between debt and equity is, in principle, something that can be resolved by a contractual analysis of the agreements and the formalities carried out by the parties. As a consequence, the form in which transactions are documented can be vital for any given country corporate and legal purposes. In this line of thought, it should be mentioned that a convertible note can be legally treated as debt until the holder exercises its option of converting it into equity and satisfies the proper formalities of a capital contribution into Company X. As the report is drafted is seems that this transaction would be targeted if the interest is

treated as interest in Country X (deductible) and in Country Y it is treated as a dividend (not as income). Other aspects must also be taken into consideration, such as the purpose of the investment and business reasons, before making a decision that the transaction is a hybrid mismatch (D/NI outcome).

Another example could be that preferred shares are legally treated as shares, even though they pay a dividend based on a specific percentage or rate that should be agreed by the shareholders, if the company has profits in that year. Thus, the result of the tax treatment can be different. Again, reasons of the investment must be taken into consideration.

Debt should be, in principle, contracted by the parties through an agreement that should mention the type of loan, its value, the name of the issuer, the term, interest or yield (or the way in which such interest should be determined), the form in which the interest is going to be paid (amortization), the time (maturity) and place of payment.

When the shareholder invests in a company through equity, a shareholders' meeting should be held and the corresponding minutes should be recorded establishing the amount of capital contributed and the way in which such capital should be paid, fulfilling specific legal procedures. As a consequence, under domestic mercantile law, residents in any given jurisdictions are able to conclude any kind of debt or equity instrument notwithstanding the place of residence of the investor, including some very specific instruments, such as subordinated notes; convertible notes/loans; fixed, variable, compounded or contingent interest rate loans; income/profit participating loans; loans in which the interest rate is fixed to a publicly traded value or index, for the purposes of the business. The proposed rules may open a discussion as to whether or not the doctrine of a jurisdiction either common or civil law can affect the implementation of said rules. This is true if the approach differs from one jurisdiction to another (form vs. substance). The report is not addressing this important concern.

7. Accounting aspects are also a fundamental part of the decision regarding the treatment of a specific transaction. For example, there are rules that are focused on determining whether a transaction qualifies as a derivative or an embedded derivative. This goes beyond just financial instruments, since a simple lease agreement may be the target of this analysis. However, the report in question does not address this issue or the issue referred to in the preceding paragraph, and it is therefore important to keep in mind that these

accounting aspects may have a significant influence on the tax treatment if we consider that certain jurisdictions rely heavily on the accounting treatment of a given item to establish the tax treatment.

8. The following questions are equally important and, in our opinion, the answer to them could be found in action plans 6 and 14. Why not question the concept of tax competition? This aspect is key, since if we analyze some of the root causes, it will be easier to understand their effects and eradicate them. Why not design a specific anti-abuse rule for certain transactions? The general consensus is that it should be this way to avoid subjectivity, as in the case in question. Why not focus on the undesired structures? The OECD in its webcast on April 2 openly addressed the double Irish Dutch sandwich)? Why not strengthen the concept of actual beneficiary? This concept has proven to be valuable. Why have rules that are so general and complex that a considerable investment (not only in time, but money as well) will be required for their application? Administrative burdens and burdens of proof that involve documenting transactions in such a way that, depending on the circumstances, will have to be presented differently for review to the different tax authorities. There should be a standard rule regarding the type of documentation required, based on the true essence of the transaction and not merely formalities. Why does it seem that the essence of the Vienna Convention is not being taken into account? The comments made in the above paragraphs gain weight if we take into account the fact that articles 26, 31 and 32 of the Convention establish that treaties must comply with the following rules: Where there is no need for interpretation, there should be no interpretation, Good faith, the object and purpose of the treaties (useful effect), their purpose, aim and natural sense, context, ulterior conduct of the parties, preparatory work (this is a very important aspect since it is where the entire essence of establishing whether the States, and not the citizens, are the parties of the treaty), subsequent practice and international law.

9. The concept of ordinary income as proposed should be reconsidered since how an exemption, exclusion, credit or other form of tax relief affects this concept is not clear. In any case, the approach to this issue should be based on whether the income is subject to taxation, regardless of whether rules have been established for considering when such payment will be considered to have been made.

10. Financial institutions (including those that can be considered as captive to the extent that they carry out activities that are subject to the same rules as

those that do not qualify under this concept) should be subject to a general safe harbor rule, as should those financial instruments considered to be of public interest or placed in recognized markets when they are considered in a primary transaction.

*  *  *  *  *

Should you have any question or comment in connection with the foregoing, please do not hesitate to contact us.

Sincerely,

IFA Grupo Mexicano, A.C.

# TAXREP 24/14 (ICAEW REPRESENTATION 59/14)

## BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

ICAEW welcomes the opportunity to comment on the public discussion drafts BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements recommendations for domestic law and treaty issues published by OECD on 19 March 2014.

This response of 1 May 2014 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

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ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 142,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.



For more information, please contact ICAEW Tax Faculty: taxfac@icaew.com

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## GENERAL COMMENTS

**1.** The two discussion drafts run to nearly 100 pages of extremely dense, and very complicated, analysis of the totality of the hybrid mismatch area and we commend OECD for the diligence and comprehensive nature of this work. But it represents an attempt to deal with all potential problems arising from hybrid mismatches without taking account of the work on other Actions, most notably Action 3 Strengthen CFC rules, Action 4 Limit base erosion via interest deduction and other financial payments and Action 5 Counter harmful tax practices more effectively, taking into account transparency and substance.

**2.** The length of the discussion draft is also a product of the two separate approaches to addressing hybrid mismatches: top down or bottom up both of which are covered in the current discussion draft. Under the top down approach the rules would apply to all transactions involving hybrid instruments with certain limited exceptions. Under the bottom-up approach the rules would apply to instruments held between related parties and instruments entered into as part of a tax-motivated "structured" arrangement.

**3.** The Press Release issued at the time the discussion drafts were published noted "the recommendations set out in the discussion drafts do not represent the consensus view of [OECD] but rather are intended to provide stakeholders with substantive proposals for analysis and comment."

**4.** We understand from the presentation of Pascal Saint-Amans at the IFS/ETPF Conference in London on Monday 28 April on International Taxation: Base erosion, profit shifting and distortions to real activity that the bottom-up approach is going to be adopted and the result of that, and more targeted provisions, is that the discussion draft will be reduced in size to some 35 pages and that it may eventually be restricted to no more than 20 pages. This will also, we understand, be the result of dealing with the issues raised in the current discussion draft through the other Actions in the BEPS Action Plan.

**5.** We warmly welcome the revised, and more targeted, approach.

**6.** As so much in the current proposals is likely to change we have not made comments on the detailed proposals in the discussion drafts in the current Representation.

**7.** We note that two of the design principles set out in the discussion draft are to be workable for taxpayers and to keep compliance to a minimum and to be easy for tax authorities to administer.

**8.** We also note that hybrid arrangements are only one of the factors that create cross-border mismatches and there needs to be a proper analysis of these other factors so that any solution is both proportionate and effective as well as tying in with the other BEPS actions.

### SPECIFIC COMMENTS

**9.** Whatever rules are finally put forward need to be compliant with EU law on the free movement of capital not least because more than half of the G20/OECD countries involved in the BEPS Action Plan as also members of the EU. Specifically, this is likely to require a commercial justification test as part of any rule counteracting the use of hybrids. See the CJEU's decisions in the Thin Cap GLO case C-524/04, and paragraph 92 in particular, and in Itelcar C-282/12 and paragraph 37 in particular.

# APPENDIX 1

## ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax/tax-faculty/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx )

Position Paper

# Insurance Europe comments on the OECD discussion draft on BEPS action 2: "Neutralise the effects of hybrid mismatch arrangements"

| | | | |
|---|---|---|---|
| Our reference: | TAX-14-055 | Date: | 6 May 2014 |
| Referring to: | OECD discussion draft on BEPS action 2: "Neutralise the effects of hybrid mismatch agreements" | | |
| Related documents: | | | |
| Contact person: | Daniel Madejski, Policy Advisor, Taxation | E-mail: | madejski@insuranceeurope.eu |
| Pages: | 7 | Transparency Register ID | 33213703459-54 |

## Introduction

Insurance Europe welcomes the opportunity to comment on the OECD BEPS action plan 2 discussion draft *"Neutralise the effects of hybrid mismatch arrangements"*.

Insurance Europe supports the aim of the Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) project to address weaknesses in the international tax environment, and recognises the OECD's concerns that some hybrid instruments can lead to base erosion. However, we are concerned that the proposed OECD rules on hybrid instruments will impact the hybrid regulatory capital of insurers. The hybrid regulatory capital issued by insurers is not designed to create tax mismatches and its use does not constitute a harmful tax practice. If this were to be impacted by the proposed OECD rules, not only would it have a disproportionate administrative burden, but it could increase the cost of raising capital and adversely affect the competitiveness of the insurance sector.

For the insurance sector "hybrid" instruments are essential for regulatory and commercial reasons as insurance companies use these instruments to meet their regulatory solvency and capital adequacy requirements. Virtually all major European insurers have issued such instruments in the market, with a total issuance greater than €10 billion[1] in 2013 alone.

Insurers reap the following benefits when issuing hybrid instruments: (1) hybrid instruments allow insurers to raise capital in a cost efficient way as debt carries less risk for the investor and, as a result, provide a cheaper form of capital than equity; (2) hybrid instruments enable an insurer to raise "risk" capital without having to issue equity and thereby diluting existing shareholders; and (3) despite their features which combine debt with equity characteristics hybrid instruments are typically bought by fixed income rather than equity investors. As a result, hybrid capital instruments broaden the investor base for regulatory capital instruments for insurers. For these main reasons,

[1] "Bank and insurance hybrid capital", January/February 2014, page 11.

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Insurance Europe strongly believes that both external (widely held and/or traded) and intra group hybrid capital issued for regulatory (and rating) purposes in the insurance sector should be explicitly exempted from the OECD rules as they are issued for non-tax purposes and cannot be in any case regarded as tax abusive.

If, despite the above concerns, a full carve out of regulatory hybrid capital is not possible then Insurance Europe believes that at the very least the following points should be considered as a matter of priority:

- The overall approach of the scope should use a "bottom-up approach". The "top down" approach is widely drawn and would result with practical difficulties in how to avoid catching innocent commercial transactions. This being said, a "top down" approach would not be manageable for both the tax authorities and the insurance companies. The necessary carve-outs would have to be absolutely correct, complete and maintained more or less "real time"

- Debt issued on the capital markets with no connection between the issuer and the external investor should not be regarded as tax abusive. Therefore and in line with the discussion draft, the hybrid financial instrument rules should only apply to related party holdings.

- A 10% threshold for the test for related party status would be too broad. There would be significant identification difficulties if the 10% threshold is maintained. Instead of this, in Insurance Europe's view the related party limit should be set at a controlling interest level. An alternative in identifying whether there is a related party would be to consider whether GAAP consolidation is required

Following these recommendations could be a way to tackle the abuse of hybrid instruments without imposing unwarranted restrictions on the tax deduction for interest on regulatory hybrid debt issued by insurers. In the below, we further clarify our position by answering the questions on hybrid instruments put forward by the OECD Discussion Paper in box 2.

## Specific Comments

1. Is it clear what elements need to be present in order for the rules neutralising hybrid financial instruments or hybrid transfers to apply?

The OECD discussion draft defines a hybrid financial instrument as "*any financial instrument (including a hybrid transfer) where a payment made under the arrangement is deductible in the payer's jurisdiction but not included by the recipient as ordinary income when the recipient calculates its net income for tax purposes*."

In Insurance Europe's view the term "ordinary income" might result in uncertainty when applying a test which instrument is regarded as hybrid. For example, the recipient jurisdiction may subject the item to a different tax rate or certain limitations from those that apply to ordinary income.

2. Is the outcome of the rules' operation clear?

Insurance Europe believes that the "outcome" of the rules' operation is not sufficiently clear. As a general remark, Insurance Europe believes that any rules concerning cross-border hybrid mismatches are inherently complex and require the full understanding of the tax treatment in two or even more countries.

Against this background, the discussion draft proposes an extremely broad and complex set of interrelated rules applying to different categories of transactions using primary and secondary "linking" rules. Furthermore several definitions which are important for the scope of the rules are unclear (widely held, related parties, ordinary income etc.)

Moreover, under the proposed rules, individual countries are given discretion to define the scope of the rules in important areas, such as the scope of transactions covered by the rules on hybrid instruments and the extent to which an item is defined in ordinary income. Insurance Europe is concerned that this might result in country-to-country variations of the scope.

It is therefore important that tax authorities introduce domestic legislation that is consistent and that there is a mechanism in place to deal with situations where there is taxability in one jurisdiction and no relief in the other – it is as important to avoid double taxation as double non-taxation.

3. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?

Insurance Europe is not aware of any arrangements which should be caught by the rules but are not addressed in the discussion draft.

4. This document sets out two possible approaches to drafting a scoping rule and summarises the possible advantages and disadvantages. Are the advantages and disadvantages accurately described and are there any other advantages and disadvantages of the two approaches?

Our response to this question is included under 5(b).

(a) What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration?

The discussion draft identifies two alternative approaches for defining the scope of the hybrid instrument rules: a "bottom-up" approach and a "top-down" approach. Under the bottom-up approach, the rules would apply to (i) instruments held between related parties, and (ii) instruments entered into as part of a tax-motivated "structured" arrangement. Under the top-down approach, the rules would apply to all transactions involving hybrid instruments, with certain limited exceptions (eg, instruments widely-held by unrelated parties).

As described above, the overall approach of the scope should use a "bottom-up approach". The "top down" approach is widely drawn and would result with practical difficulties in how to avoid catching innocent commercial transactions. This being said, Insurance Europe recommends that the definition of hybrid instrument be limited to investments in debt or equity of a related party. This would, by definition, limit the rules to related-party transactions.

5. This part includes a number of examples:

(a) What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties position?

The answer to this question is covered in our response to questions 6 and 8.

(b) In this context are there any examples or situations that are more problematic than others? If so please explain why problems arise and what constraints or restrictions the parties might face in obtaining relevant information on the treatment of the counterparty?

Insurers invest the premiums received from policyholders in a broad range of instruments. With a "top down" approach there would be a significant and unreasonable compliance burden to expect insurers to review all their investments and to identify the tax treatment in the issuers' jurisdiction(s). This is particularly so as the scope of "instruments" covered by the proposed rules is very broad. However, with a "bottom up" approach there would not be the same problems provided that the related party limit was increased to a more appropriate level to ensure insurers' portfolio holdings are not related parties.

There would be a further problem where the profits and gains of a particular class of insurance business is exempt from tax. Life insurers invest in hybrid instruments for commercial investment purposes to support policyholder liabilities.

Insurance Europe therefore suggests that there should be no requirement to identify the "ordinary income" where hybrid instruments are held to support the business of life insurers where in practicable terms the income of that business is exempt from tax. Failure to do this might result in life insurers ceasing to make such investments, because of concerns around tax compliance failures, which may result in a negative impact on capital markets.

(c) To the extent that there are difficulties, do these apply equally to both the holder and issuer in the context of hybrid financial instruments?

The discussion draft rightly notes that in case only investors would be subject to the proposed rules, information reporting might nevertheless be required also by issuers. Therefore, we recommend that in case of externally issued regulatory hybrid capital by issuers both, parties should be excluded from the rules. However, the difficulties for issuers would be greater, because in most cases it would be nearly impossible for them to identify the holders of insurers' regulatory hybrid capital for the reason given in our response to question 6. In contrast, the holder would at least know it had a holding in an insurers' regulatory hybrid capital, even though they would not necessarily know the tax position of the issuer.

Even if an insurer could identify all related parties holding its regulatory capital, it would be extremely difficult to assess the amount of relief. It is possible that a holder may not be a related party for a whole year, therefore the amount of relief would vary overtime and create uncertainty for an insurer.

Significant difficulties would also arise for insurers as investors. Insurers invest the premiums received from policyholders in a broad range of instruments. With a "top down" approach there would be a significant and unreasonable compliance burden to expect insurers to review all their investments and to identify the tax treatment in the issuers' jurisdiction. This is particular so as scope of "instruments" covered by the proposed rules is very broad. However, with a "bottom up" approach there would not be the same problems provided that the related party limit was increased to a more appropriate level to ensure insurers' portfolio holdings could not be related parties.

(d) Are there any other situations or examples, not covered here that give rise to difficulties? In particular are there any specific problems for regulated businesses (see also Q. 8 below)?

Where an insurer issues regulatory hybrid capital externally there will be a large number of holders of that capital. Usually more than one tranche of regulatory hybrid capital will have been issued, therefore the total number of holders of an insurers' regulatory hybrid capital will be large.

Therefore, unless externally issued regulatory hybrid capital is carved out from the hybrid financial instrument rule, in addition to the identification difficulties, to which we refer to in our response to question 6, there would be a significant administrative burden in ascertaining the tax treatment in each holder's jurisdiction. This would be disproportionate, particularly in view of the fact that insurers' regulatory hybrid capital is not designed to create a tax mismatch.

6. What definition could be used to capture the concept of widely-held or regularly traded whilst also addressing concerns that any exemption should not be available to related parties, parties acting in concert or parties to a structured arrangement (i.e. an arrangement designed to obtain the benefit of a mismatch).

In our response to the above questions, Insurance Europe would like to comment on regulated hybrid capital externally issued by insurers. Insurance Europe's comments on internally issued regulatory hybrid capital by insurers are covered in question 8.

The discussion draft in paragraph 160 (page 42) assumes that that Additional Tier 1[2] instruments issued directly to the market are unlikely to be caught by either a related-party hybrid mismatch rule, or a more widely drafted rule that contains a specific carve out for 'widely-held' or 'traded' instruments. As further elaborated below, in our view this might be too optimistic and not correct with respect to externally issued external regulatory hybrid capital by insurers.

Even under the "bottom-up" approach externally issued regulatory hybrid capital by insurers can be caught by the 10% related party test threshold as insurance companies may have portfolio holdings where the percentage of the share capital held exceeds 10%. A life insurer receives substantial premiums from policyholders which it invests to support policyholder liabilities. The size of the premiums invested means that it is not unusual for life insurance companies to have what are properly regarded as portfolio holdings where the percentage of the share capital held (or the interest held via an investment fund) exceeds 10%, being the proposed related party test threshold in the discussion draft.

[2] "Additional tier 1" is a concept used under Basel 3; under Solvency II, the comparable type of instruments are called "restricted tier 1" instruments. Even though the instruments will differ, we use both terms synonymously.

According to the OECD discussion draft, once an investor is classified as a related party, an insurer would be obligated to obtain relevant information on the tax treatment of these instruments in the tax statement of the investor. As mentioned above, in the context of externally issued regulatory hybrid capital by insurers, this would be nearly impossible.

Regulatory capital hybrid instruments issued by insurers are typically placed in the market in the form of bonds. These instruments are sold to international investors via banks, which buy the bonds from the issuer and immediately sell them to investors. Therefore, in principle there is no direct contact between the issuing insurance company and the investors.

Furthermore, even on the day of pricing of a new transaction the issuing insurance company has only incomplete information on the identity of the bond investors for several reasons. For example large investment funds buy bonds in their name, but then distribute them to various funds (potentially based in various countries) with no information available to the issuer.

Similarly to the primary market, on the secondary market the issuers have no insight on the trading activities. There is no requirement to hold a register of the owners of the externally issued regulatory hybrid capital. There is therefore no comprehensive record of the current holders of regulatory hybrid capital.

Also during the payment process, there is no direct contact between issuer and holder because the issuers typically employ paying agents (banks) to receive coupon and principal payments. After receiving the payments from the issuer the paying agent forwards them to the clearing system which then forwards the payments to the various depository banks, which then process the payments to investors.

Furthermore, as the level of shareholding is likely to change over time, an insurer would be required to permanently monitor who owns its shares and securities as well who owns its regulatory hybrid capital. This would create a disproportionate administrative burden for instruments that cannot be regarded as tax abusive.

Finally, assuming that an insurer could identify all related parties holding its regulatory capital, it would be extremely difficult to assess the amount of relief. It is possible that a holder may not be a related party for a whole year, therefore the amount of relief would vary overtime and create uncertainty for an insurer.

Because of these reasons, in most cases it would be virtually impossible for an insurer to identify the holder of its regulatory hybrid capital and to fulfil any requirements to prove that payments are included in the taxable income of the holder of these instruments.

Therefore, we strongly recommend that all (both unrelated and related party) external regulatory hybrid capital issued by insurers is carved out from the rule. This is because it will in most cases be nearly impossible for insurers to identify all the holders of their externally issued regulated hybrid capital and the tax treatment in the holder's jurisdiction.

If it is not possible for there to be a complete carve out for regulatory hybrid capital of insurers then we would strongly recommend that a "bottom up" approach is taken and:

- Only related party holdings are included.
- The related party limit is set at a level that would not capture insurers' portfolio holdings. This would also have the benefit that it would exclude the vast majority of parties who are related simply because they have a minority shareholding in an insurer.

As regards the related party definition, Insurance Europe believes that if the definition was that of a controlling interest then it is highly unlikely an insurer would have any difficulties identifying related parties. Insurance Europe acknowledges that some jurisdictions may regard controlling interest as being too high.

An alternative to identifying whether there is a related party would be to consider whether GAAP consolidation is required. The benefit of this is that it would be based upon objective tests that groups have to apply in drawing up their statutory accounts. It would also ensure that the rule is targeted at situations where there is genuine (and purposeful) economic connectivity between the parties genuine. We believe that this addresses the situations set out

in paragraph 128 of the discussion draft. Taking IFRS 10 ("consolidated financial statements") as an example, the key principals are that that control exists and consolidation is required, only if the investor "*has power over the investee, exposure to variable returns from its involvement with the investee and the ability to use its power over the investee to affect its returns"*. There should be a reassessment if facts and circumstances indicate changes to any of these elements.

The definitions of the ability to affect returns, exposure to variable returns and power over the investee are:

- Power over the investee

  "existing rights that give the current ability to direct the relevant activities". The relevant activities are those that significantly affect the investee's returns, such as voting rights, appointment rights etc.

- Exposure to variable returns

  Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee, eg dividends, management fees and returns not available to other investors.

- Ability to affect returns

  This considers the interaction between the first two steps, namely whether the investor has the ability to use its power to affect the investor's returns from its involvement with the investee. The key consideration when assessing investment funds is whether the investor is a principal or agent. It is acting as principal that is important, ie acting on its own account and not that of another party. Consideration here is given to such as scope of authority, rights held by third parties and remuneration.

<u>7. If the rule exempted certain traded instruments then how could it be drafted so that it still applied to structured arrangements and 8. In relation to regulatory capital</u>

<u>(a) What are the regulatory requirements for banks' to issue/manage capital at top holding company level, and what arrangements are used to pass this down the group? For example, what use is made of identical and traceable instruments and under what conditions would the arrangement be funded by a market issuance at top holding company level?</u>

According to the discussion draft, as a result of regulatory requirements, banks are encouraged by regulators to raise capital through so called "single point of entry" resolution, where loss absorbing capital is issued at top holding company level and then passed down through the group to the relevant subsidiaries.

Insurance Europe would like to underline that a similar situation exists in the insurance sector. In the context of insurance, different commercial factors that might impact on the decision on where to issue regulatory hybrid capital include regulatory aspects, taxing considerations and the issuers policy regarding its approach to capital markets under Solvency II, instruments issued by group members other than issued by the entity which heads the group are deemed to be unavailable – and thus ineligible – for group capital purposes. While there are potential exemptions to these standard rules, some groups will be forced to execute all external hybrid capital issuance from the entity which heads the group level.

In addition, rating agencies favour issuance of hybrid capital instruments by the entity which heads the group - according to the agencies' insurance capital methodology. As a result of these considerations regulatory hybrid capital might be issued externally by the entity which heads the group for other companies in an insurer's group.

Furthermore, whether there is an external issue will depend on the overall capital and funding situation of the group. For example, if the group has sufficient cash and regulatory surplus at the group level and there is commercial and regulatory need for hybrid capital at the level of a subsidiary, this will be achieved through intra-group transfers. Such intra-group transfers should not be subject to hybrid mismatch rules.

Therefore, the issue of regulatory hybrid capital because of regulatory requirements and is not issued to create tax mismatches. As such, Insurance Europe believes that where regulatory hybrid capital is issued for regulatory purposes, intra-group issues should be carved out in addition to those issued externally. So there should be a full

carve out for insurers' regulatory hybrid capital unless structured arrangements are involved. If the full carve out is not possible, the hybrid financial instrument rules should be limited to intra-group hybrid debt where it cannot be evidenced that the holder of the instrument is subject to taxation on the income.

(b) Are special provisions needed to create parity between a banking group issuing hybrid regulatory capital indirectly to the market through its holding companies and a banking group (or another industry group) issuing hybrid regulatory capital directly to the market?

The answer to this question is covered in our response to question 7(a).

(c) Are hybrid regulatory capital instruments sufficiently different as to justify a full carve-out from hybrid mismatch rules? Are there inherent safeguards in place against the use of these instruments for tax-planning purposes or what safeguards could be introduced to ensure that any exemption from the general hybrid mismatch rules could not be abused?

The regulatory hybrid instruments issued for both internal and external purposes are very different compared to other hybrid instruments.

Insurers' regulatory hybrid capital forms an integral part of the capital of insurers and is therefore essential in supporting the trading operations of the insurance industry. Although, all industries require capital to operate, insurers are required to hold their capital subject to specific regulatory rules.

The issue of hybrid regulatory capital is driven by regulation. Insurance groups are required to meet capital adequacy standards and the hybrid regulatory capital which can count towards their capital has certain equity-like features mandated by the local regulators (or the European regulators when Solvency II comes into effect in 2016) relating to loss absorbency and interest deferral.

May 2, 2014

# BEPS Action 2: Hybrid Mismatch Arrangements

Comments by the Insurance Company Working Group on BEPS

## I. Introduction and Summary of Recommendations

These comments are being submitted to the OECD by the Insurance Company Working Group on Base Erosion and Profit Shifting (BEPS), which consists of insurance companies conducting international business, in response to the public discussion draft titled *BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* (the "Draft").

Our main comments may be summarized as follows:

- The recommended anti-hybrid rules in the Draft are based on design principles that seem, in part, to be ill-suited to attaining the stated policy goal of preventing the use of hybrid mismatch arrangements to achieve BEPS outcomes. Specifically, adopting the design principles of comprehensiveness and automatic application has led to recommendations that would apply an anti-hybrid rule to transactions that are not tax-motivated, thereby creating unnecessary compliance burdens and potentially distortionary effects.

- We believe that a "bottom-up" approach to designing rules for hybrid financial instruments and transfers is the only practical approach. It does not seem possible to anticipate all of the potential transactions that should be excepted from a broad rule that would otherwise cover all hybrid financial instruments and transfers.

- We strongly agree with the suggestion in section IV.E of the Draft that hybrid regulatory capital of regulated financial entities, including insurance companies, should be outside the scope of any recommended anti-hybrid rules. The hybrid financial instruments in this category are not used for BEPS purposes, are widely issued on a commercial basis, are issued pursuant to regulatory approval, and are supervised by the regulator on an ongoing basis. Such instruments have been issued to provide both long-term capital to the issuer and a long-term investment to the holder.

- The Draft should be modified to clarify that sale and repurchase transactions ("repos") entered into in the ordinary course of business by a financial institution

are outside the scope of any recommended anti-hybrid rules, as they are secured loans that do not give rise to BEPS concerns.

- We have concerns about the lack of clarity regarding the core question of how to determine whether an income item has been included in ordinary income for tax purposes by the recipient. Similarly, we are concerned that the open-ended definition of "financial instrument" could lead to differing definitions in different jurisdictions.

## II. Mismatch between policy objective and design principles

The Draft sets forth a number of anti-hybrid recommendations, including a hybrid financial instrument rule (at paragraph 81), based on design principles which are stated in paragraph 27. These principles include standard tax policy goals such as clarity, administrability, and neutrality, in addition to more unusual concepts such as comprehensiveness and automatic application (as opposed to application based on an exercise of objective analysis and judgement). We have concerns about these latter two design principles, as they do not appear to be consistent with the objectives of the OECD and G20 regarding BEPS and hybrid mismatches.

The Background discussion on pages 4-5 (paragraphs 1-6) of the Draft indicates that the policy objective is to address "tax planning schemes involving hybrid mismatch arrangements" which are described on page 8 (paragraph 16) as "arrangements [that] incorporate techniques that exploit a difference in the characterization of an entity or arrangement under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes." It seems clear that the objective is to address transactions motivated by tax considerations, and not to address non-tax-motivated transactions.

This is supported by paragraph 22, which most significantly states that "the focus of Action 2 is on arrangements that exploit differences … in order to achieve profit shifting and base erosion outcomes. Action 2 is not intended to capture all arrangements that have the effect of lowering the aggregate tax burden of the parties to an arrangement."

The design principles in paragraph 27, however, seem to be in conflict with the main objectives that are asserted earlier in the Draft. In particular, the design principles call for automatic application of comprehensive rules that operate to eliminate all mismatches. There is no mention of targeting the rules so that they apply only to mismatches that were deliberately achieved as part of a tax plan. Moreover, paragraph 32 states that there is no need for "a qualitative assessment of whether the arrangement has been used to erode the domestic tax base" of the country applying an anti-hybrid rule, because the OECD is recommending "a multilateral approach which applies the hybrid mismatch rule to any hybrid arrangement that has the effect of lowering the overall global tax rate of parties affected by the arrangement." However, this statement seems to contradict the statement in paragraph 22 noted above.

The Draft states in paragraph 28 that "the [anti-hybrid] rules are intended to drive taxpayers towards less complicated and more transparent tax structuring," which implies that the hybrids subject to the rules are complicated and non-transparent. But at the same time the Draft recommends a comprehensive and automatic set of anti-hybrid rules that apply to any transaction that results in a tax mismatch, including common and straightforward transactions such as the issuance of redeemable preferred stock, if it is viewed as equity in the investor's country and as debt in the issuer's country.

The Discussion Draft does not provide a convincing rationale for a comprehensive, automatic set of anti-hybrid rules that apply regardless of whether a tax mismatch was intended. Instead, Paragraph 30 simply states that if the rules are not comprehensive, taxpayers will be able to avoid them. This does not explain why the rules should apply to transactions that do not give rise to policy concerns. Paragraph 32 says that if the rules are not automatic, they will be less efficient and consistent in their operation. Again, no reason is given for applying the rules to transactions not motivated by tax considerations.

The suggested anti-hybrid actions (ii), (iii), and (iv) in the BEPS Action Plan (reproduced in paragraph 8 of the Draft) seem to have been interpreted as mandatory instructions to issue recommendations regardless of whether the recommended rules are overbroad.

Our comments below will elaborate on how the recommendations can be tailored to apply only to the hybrid mismatches that give rise to policy concerns.

## III. Bottom-up versus top-down approach, and other scope issues

In order to best address concerns about the overly broad scope of the anti-hybrid recommendations in the Draft, the bottom-up approach should be used, rather than the top-down approach, in formulating the rules.

As noted in our comments above, the BEPS concern about hybrid mismatches is limited to tax planning arrangements. Therefore, a top-down approach involving a comprehensive rule with exceptions does not seem appropriate. (This point seems to be acknowledged in paragraphs 141 and 142 of the Draft.) A bottom-up approach that identifies objectionable hybrid mismatch arrangements with specificity is more appropriate, primarily because, as is stated in paragraph 137, the bottom-up approach can limit the scope of the anti-hybrid rule to the transactions that give rise to BEPS concerns.

More specifically, a more targeted approach is embodied in the statement in paragraph 121(b) that an anti-hybrid rule would most appropriately apply to structured arrangements designed to produce a mismatch in tax outcomes. The factors listed in paragraph 131 could more effectively be included as relevant factors to be considered in applying such a rule. In addition, it would be relevant to consider whether the parties

to the transaction are commonly controlled and whether the transaction was on arm's length terms.

We have some concerns, however, about the broad statement in paragraph 121(a) that an anti-hybrid rule should apply whenever the issuer and investor with respect to a financial instrument are related parties, including persons deemed to be acting in concert, without regard to other facts and circumstances that might show an absence of tax planning. Our concerns are heightened by the proposal in paragraph 128 to use a 10% ownership threshold to define related persons, supplemented by broad "acting in concert" rules that deem a person to own or control voting rights or equity interests owned by another if any of several relatively general conditions are considered to exist. These rules would unnecessarily create uncertainty and compliance burdens with respect to financial transactions between parties dealing at arm's length. At a minimum, a taxpayer that is considered related to the counterparty on a hybrid financial instrument should have the opportunity to rebut a presumption that an anti-hybrid rule is applicable. In addition, to support such a presumption, the common ownership threshold for related-party treatment should be "greater than 50%."

We support the Draft's proposal to take widely held instruments out of scope, but a top-down approach necessitates crafting of a definition of "widely held" that appears impossible to accomplish. A more targeted, bottom-up approach eliminates this very important design problem. It does not appear to be possible to define "widely held" in a way that would be administrable in practice and lead to appropriate results. Debt instruments are often issued to a relatively small group of institutional investors who then sell part or all of the instruments to other investors over time. Obtaining information about the number of holders of a particular financial instrument at any given time would be impractical. This practical consideration reinforces the conclusion that the bottom-up approach is the correct one.

Moreover, we have concerns about the suggestion in paragraph 150 that an exemption for widely-held instruments should be limited to the issuer's side of the transaction, so that holders would be required to include a payment on a widely held instrument in taxable income if the issuer was entitled to a deduction. It is hard to see a justification for this, in part because the tax policy principle of horizontal equity would appear to be violated under such an approach. Such an approach would mean that an investor in a widely held instrument issued by a foreign issuer would be taxed differently from a similarly situated investor resident in the same jurisdiction who had invested in an identical instrument issued by a domestic issuer, to the extent that the investors' return would be tax-exempt under domestic law but one investor would be taxed under an anti-hybrid rule simply because the foreign issuer was able to claim a deduction for foreign tax purposes.

For example:

> *Taxpayer 1, a resident of Country A, invests in a widely held perpetual debt instrument issued by Fast Growth Co., a resident of Country A. Taxpayer 2, also a resident of Country A, invests in a similar widely held perpetual debt instrument*

*issued by FGC plc, a resident of Country B. Country A treats each instrument as equity for tax purposes; Country B treats the instruments as debt and allows a deduction to FGC plc for interest paid thereon. Neither Fast Growth Co. nor FGC plc has any earnings and profits for the year in question. Taxpayer 1 has no taxable inclusion for payments received from Fast Growth Co., which are treated as a nondeductible return of capital under Country A law. If an anti-hybrid rule applied, Taxpayer 2 would have to include payments received from FGC plc in taxable income in Country A because the payments are deductible in Country B. (This example assumes that the terms of the instrument do not give any of the tax benefit of the deductions to Taxpayer 2, and that all of the parties are unrelated to each other.)*

Horizontal equity requires that Taxpayer 1 and Taxpayer 2 be treated the same way under Country A tax law with respect to payments received on their similar investments. There does not appear to be a policy justification for an anti-hybrid rule that would impose tax on Taxpayer 2 solely because deductions were available under foreign law to the unrelated foreign issuer of the widely held instrument held by Taxpayer 2.

Leaving aside the possibility of instruments issued into the capital markets as part of a structured hybrid mismatch arrangement (a possibility that is surely remote), there is no BEPS concern to be addressed in the case of hybrid instruments issued to the market. The holders of such instruments do not acquire them in order to obtain a tax benefit, nor do the issuers issue them for tax reasons.

## IV. Hybrid regulatory capital and insurance companies

The Draft acknowledges, in Section E, paragraph 158, that the treatment of bank hybrid regulatory capital is an important issue that must be taken into consideration in developing rules for the tax treatment of hybrid instruments and structures. While certain types of bank regulatory capital raised through instruments issued directly to the market would be out of scope under either a bottom-up or top-down approach, the movement of this capital down through a group into locally regulated entities would potentially be captured by the rules for related-party arrangements. The Draft correctly raises issues and questions as to whether this movement of capital into subsidiaries, through the issuance of intra-group instruments, should be in scope given that it is being held for regulatory purposes. However, while the Draft refers to the regulatory requirements for banks and the related tax implications in some detail, it fails to identify the similar requirements for insurance companies. We believe it critically important that the regulatory and competitive market environments in which insurance companies operate be similarly accommodated as part of any final recommended rules relating to hybrid instruments.

In particular, both banks and insurance companies are guided by their regulators to raise a portion of the capital that they are required to hold through instruments that have both debt and equity-like features, such as mandatory conversion to ordinary shares

that are viewed as able to absorb losses in the event of financial stress. For banks, these instruments are generally referred to as Additional Tier One (AT1) capital as defined under Basel III. For insurance companies, as described in further detail below, the capital requirements currently vary by jurisdiction but are becoming more unified in Europe under Solvency II, and are becoming similar to the rules for banks. We believe that it is absolutely necessary to allow, without a tax penalty, the issuance of regulatory capital at the EU parent company level or “the top of the house” by insurance companies and to similarly accommodate practices, required by regulators, to pass this capital down the group into local country subsidiaries through the use of intra-company hybrid regulatory capital instruments.

*Overview of insurance industry and regulatory environment*

Regulators supervise insurers in order to ensure that all insurance liabilities to policyholders can be met and, accordingly, require insurers to hold capital[1] in order to cover potential liabilities and support future stability. The form of capital which may be held by an insurance company is heavily governed by regulation, particularly in relation to the matching of investment assets to insurance liability exposures, asset default risk and volatility risk. Capital requirements are determined by reference to insurance liabilities, particularly risk volumes, profile and diversity of risk. Without capital, an insurer cannot operate and it is therefore a critical measure of an insurer's economic position[2].

Regulatory rules currently vary by jurisdiction. In the United States, insurance regulation is largely determined by State regulatory bodies, though certain insurance companies that have been designated as nonbank systemically significant financial institutions (SIFIs) face both State and Federal Reserve regulation, as explained further below. Across Europe, individual countries have developed their own regulatory frameworks for local insurance companies. However, a European framework for insurance regulation that has been in a state of evolution and standardization is now becoming more uniform. An EU framework has been in place since the early 1970's that enables insurers to conduct business across the EU on either a Freedom of Establishment (“FoE”) or Freedom of Services (“FoS”) basis and that outlines capital requirements (Solvency I). FoE and FoS provisions mean that operations with a head office in the European Economic Area are permitted to conduct insurance and reinsurance business in other EEA member states (either directly or through branches) but are only required to be authorized in their Home State (known as "EU Passporting"). It is recognized that EU entities operating in this way should not be disadvantaged as

[1] The OECD Report on the Attribution of Profits to Permanent Establishments (Part IV-Insurance), paragraph 15 states that "capital" means the equity of an insurance company, but notes that the term has a multitude of facets. It is used as an accounting term (paid-in capital and accumulated profits or losses not distributed to shareholders). It is also relevant for regulatory purposes (where capital is often referred to as surplus or "free assets") and is defined under the various country-specific regulatory provisions. The Solvency II term is “Own Funds”. It is also used in connection with creditworthiness (ratings issued by independent rating agencies to indicate level of financial strength to clients and creditors), which is particularly important for long-term business.

[2] As recognised by the OECD in the OECD Report on the Attribution of Profits to Permanent Establishments (Part IV – Insurance). The OECD concludes that the functions which put capital at risk are the functions which most directly impact the profitability of an insurance enterprise.

compared to local insurance entities. Many insurance groups operate pan-European businesses through direct sales or branch structures.

The EU Commission is currently in the process of introducing harmonized insurance regulation ("Solvency II"), which has been in development for the last decade. Solvency II is expected to be introduced with effect from 1 January 2016[3] for all insurers operating in the EU. It will prescribe certain capital requirements and govern the assessment, quantification, and disclosure of all insurance, financial, and operational risks of an insurance group.

*Use of hybrid regulatory capital in the insurance industry and regulatory constraints*

Although Solvency II is not due to be implemented until 2016, some regulators, such as the Prudential Regulation Authority in the UK, have required insurance companies to assess capital adequacy in line with draft Solvency II regulations for some time. This requirement encompasses the quantification, assessment, and disclosure of insurance risk and also the form of capital being held by the insurance companies. Under Solvency II, capital is categorized in three tiers. Tier 1 capital includes common equity capital as well as preferred equity and subordinated debt capital if certain conditions are met (see note 4, below). Tier 2 capital is somewhat less like pure equity and Tier 3 capital is still less like pure equity, but all three tiers of capital, as defined in the Solvency II directive, are available to absorb losses. Hybrid regulatory capital instruments can be either Tier 1 or Tier 2, depending on their particular terms.

Tier 1 capital must make up at least 50% of an insurer's total regulatory capital. Tier 3 capital, in contrast, must be less than 15% of the total. Of the Tier 1 capital, only a limited portion (up to 20%) can be in the form of subordinated notes.

Thus, insurers are limited in the extent to which they can raise hybrid capital in Tier 1 and Tier 2 forms in order for the regulator to closely monitor and restrict capital held in a form that is less loss-absorbent than common equity. In this way, the regulator is looking to ensure that the insurer is able to meet its liabilities. Under Solvency I and Solvency II, EU regulators consider the capital adequacy of a consolidated group of entities, taking into account the structural and geographic diversity of the component insurance portfolios. Accordingly, capital issuances may inherently be required by regulators on a consolidated basis and, therefore, at the level of the group's EU holding company (effectively, the Solvency II top company) which may, or may not, be the group's parent company depending on whether or not the group is ultimately parented by an EU resident company.
These instruments are issued by insurance companies not for purposes of reducing their taxes but for purposes of complying with regulatory mandates that protect policyholders, and because the cost of capital on such instruments is notably less than

[3] On 11 March 2014 the European Parliament adopted the Omnibus II Directive following a plenary vote. This confirms that Solvency II remains on course for transposition by 31 March 2015 and implementation on 1 January 2016 (http://europa.eu/rapid/press-release_STATEMENT-14-61_en.htm?locale=en)

the cost of capital on equity issuance. It is precisely those features of the instruments that protect policyholders that give rise to the instruments' hybridity, i.e., because repayment is contingent and subordinated to the interest of policyholders.

Furthermore, a denial of deductions for payments on these instruments would drive up the cost of capital for insurance companies operating in the countries where these rules are in place. Any increase in capital costs will likely reduce available insurance capacity and therefore result in upward pressure on the cost of insurance premiums.

*Current proposed legislation*

On 14 March 2014 the EU Commission issued the latest Solvency II Delegated Acts. This legislation confirms the key attributes of an insurer's capital which are required in order for capital to be treated as Tier 1 for regulatory purposes[4]. Additionally, as part of on-going consultation with the insurance industry in the transition to Solvency II, HM Treasury in the UK has now included in the Finance (No.2) Bill 2014[5] further provisions in relation to the granting of tax relief to insurers for interest on Solvency II-compliant regulatory capital (analogous to that for banks applying Capital Requirement Directive IV ("CRD IV") under Basel III).

*Regulatory and capital requirements for US non-bank SIFI insurance companies*

In the wake of the economic crisis, the US Congress included provisions in the Dodd-Frank Act to subject nonbank financial companies to consolidated federal supervision by the Federal Reserve. Section 165 of the Dodd-Frank Act creates a process for the Financial Stability Oversight Council (FSOC) to designate nonbank financial companies as systemically important financial institutions, or SIFIs. To date, two insurers have been designated by the FSOC as SIFIs and another is under review by FSOC for designation. Once an insurance company is designated by FSOC as a SIFI, the company is subject to supervision by the Federal Reserve and other requirements under Dodd-Frank, including consolidated capital requirements. These include stress testing requirements that are also applicable to banks. In addition, insurance companies designated as SIFIs are expected to become subject to further enhanced prudential standards under Dodd-Frank section 165. Such enhanced standards may include enhanced capital requirements, capital plans, qualitative liquidity standards, risk management standards, single counterparty credit limits, enhanced market disclosure requirements, "living wills", and enhanced risk management requirements.

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[4] Article 59 of the Draft Delegated Acts, Solvency II, provides that an instrument should display the following features in order to be classified as Tier 1. Specifically it must be:

- Loss absorbent, such that:
  - Principal can be written down;
  - Automatic conversion to common equity; or
  - Principal loss absorbency mechanism.
- Undated, perpetual;
- Repayable (after 5-10 years) only at borrower's option and subject to Regulator's approval based on Solvency Capital Requirement test. Lender cannot call.
- Fully flexible for distribution (other than where there is a breach of the Solvency Capital Requirement).

[5] Section 221 FA 2012 augmented by what is currently clause 288 F(No2)B 2014

*Similarities / differences from banking industry*

Many of the features of the Solvency II regime were drawn from the regulatory framework for the banking sector, Basel II, implemented in 2004. As a result of the financial crisis the Basel II framework was augmented and Basel III was developed.

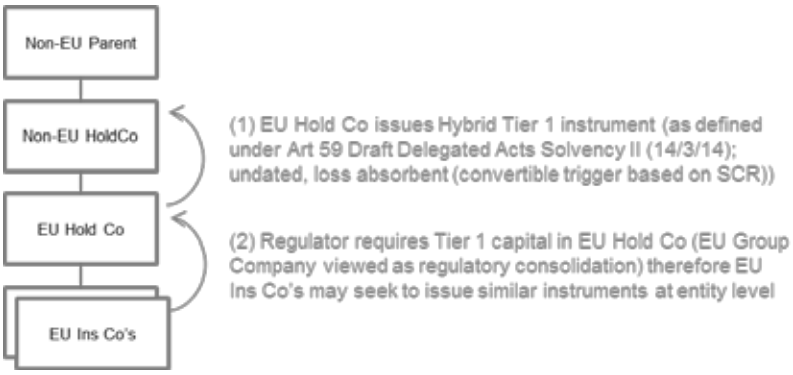
Under Solvency II and Basel II/III, both industries are subject to similar levels of scrutiny relating to capital adequacy, reporting requirements, and disclosure. The main differences between the industries relate to the business models which drive the need and mechanism for regulators to supervise capital adequacy. For example, in a banking context, business is focused on the creation and management of assets, often supported by leveraged balance sheets. The insurance industry is focused on the assumption and management of risk. As a result of the business model and regulatory restrictions, insurers are not typically heavily leveraged, with the median debt:equity ratio typically being around 0.3:1 for both the life and non-life industries.

Both the banking and insurance regulatory frameworks provide for the use of hybrid regulatory capital instruments. In the banking context, these requirements are contained within AT1 provisions, while the Solvency II provisions for insurance companies include these in either Tier 1 or Tier 2 (as outlined above). However the core requirement of loss absorbency is consistent between both industries.

The issues identified in the Draft on hybrid regulatory capital in the context of the banking industry are therefore very similar to those faced in the insurance industry.

Specifically, it is possible, under both the current and proposed regulatory regimes, for insurers to issue capital in hybrid form under supervision of the regulator. It is often a requirement of the regulator for this instrument to take specific legal form, at the level of the EU parent entity, and to be rated by a ratings agency.

Historically, many global insurance groups issued hybrid regulatory capital instruments to the market as opposed to related parties. The emerging regulatory standards will solidify this practice at the holding company level. Capital raised in the market has typically been passed down to operating insurance companies in the form of equity or, in some cases, debt. These issuances can sometimes be directly linked to market issuances at the holding company level, or they may not be directly linked and thus not directly traceable to lower-tier subsidiaries -- for example, where an EU-parented sub-group governed by Solvency II is held by a non-EU parent outside of the Solvency II regime. In this example, it could be the case that the EU Hold Co may be located in a country (for example, the UK) that may view payments on such an instrument as tax deductible, whereas the investor entity (the non-EU Hold Co in this example) may be located in a jurisdiction that may not seek to tax those payments. Accordingly, there would be a mismatch.




*Intra-group hybrid capital instruments should be out of scope*

Paragraph 160 of the Draft states:

> "it is assumed for the purposes of discussion that AT1 Instruments issued directly to the market are unlikely to be caught by either a related-party hybrid mismatch rule or a more widely drafted rule that contains a specific carve out for 'widely-held' or 'traded' instruments. However, as a result of regulatory requirements, banks are increasingly constrained in their ability to raise capital in this way. As part of a wider move towards a 'single point of entry' resolution, a number of regulators are encouraging banking groups domiciled in their jurisdiction to issue all their loss absorbing capital at top holding company level and then pass this capital down through the group to the relevant subsidiaries."

In the accompanying Questions for Consultation, the Draft further identifies the tax issues that must be resolved in the context of hybrid mismatch arrangements in order to ensure that practices required by financial regulators are not impeded. As noted above, all these considerations apply to insurance groups.

We believe that intra-group regulatory capital instruments should be made out of scope. The following policy considerations are critically important:

- In this context, the existence of the hybrid financial instrument is driven by regulatory requirements. As noted above, under Solvency I and Solvency II, EU regulators of an insurance group consider the capital adequacy of the consolidated group of entities, taking into account the structural and geographic diversity of the component insurance portfolios. Accordingly, capital issuances may inherently be required on a consolidated basis and, therefore, at the level of the group's EU holding company (effectively, the Solvency II top company) which may or may not be the group's parent company, depending on whether the group is ultimately parented by an EU resident company.

- Therefore, the necessity of the intra-group hybrid capital instrument is driven by the fact that the lower-tier subsidiary often cannot issue capital-related instruments to the market itself because the regulator of the group generally requires that the instrument be issued "at the top of the house," i.e. the top EU

company. This requirement generally exists because regulatory capital held in a parent company can more easily be redeployed to group members than capital that would be "stuck" in lower-tier subsidiaries.

- Capital can become "stuck" in lower-tier subsidiaries because the regulator of a subsidiary must approve movement of the capital from its jurisdiction to another jurisdiction. This is particularly the case for equity capital, which can require a substantial period of consultation with regulators before such equity capital can be released.

- The transfer of capital to lower tier subsidiaries through intra-group hybrid instruments is oftentimes required by regulators to be accomplished on a true arm's-length basis as most regulators want the insurance subsidiaries operating in their jurisdictions to be as independent as possible, from a capital and management standpoint, from their parent companies. This independence, which can run counter to the requirements of the parent company's home country regulator, is sometimes demonstrated by the regulatory requirement that the subsidiaries include non-management members on their boards. As local, stand-alone insurance companies are able to readily issue hybrid capital instruments to the market, while local subsidiaries of a multinational insurance group generally must obtain hybrid capital through intra-group arrangements, it is a matter of tax fairness that both be allowed a deduction in regards to the instruments. If the tax deductibility of the intra-group hybrid instrument were to be compromised through a rule addressing related-party hybrid instruments, the local subsidiary would be forced to operate at a significant competitive disadvantage in comparison to local insurance companies. The local insurance companies would benefit from the fact that their widely-held instruments have been made out of scope under the Draft. From a regulatory perspective, the local subsidiary would be treated as an independent insurance company, subject to the capital requirements of other insurance companies in the local marketplace, but from a tax perspective it would be discriminated against as a member of a larger insurance group.

- Furthermore, the position for local branches of foreign insurers needs to be considered. As outlined above, many insurers operate through European branch structures, but capital is typically held centrally at the European head office level. The principles of the attribution of capital to insurance permanent establishments as outlined in the OECD Report, Part IV[6], envisage that the overall entity's capital should be allocated to branches to reflect the extent to which branches put capital at risk. Therefore branches that have been allocated hybrid capital would face the same issues as subsidiaries of foreign insurers and, accordingly, be disadvantaged as compared to their local insurance counterparts. Please note that the Draft is silent on how the proposed rules would apply where the hybrid debt instrument and the accompanying interest charge is allocated to permanent

[6] OECD Report on the Attribution of Capital to Permanent Establishments (Part IV – Insurance)

establishments rather than the head office, and greater clarity on this matter would be welcome.

- Finally, it is also important to note that in this typical structure described above, there is only one net tax deduction for the group; in other words, deductions do not multiply down through the chain of subsidiaries.

As noted above, the amount of hybrid regulatory capital that a regulated financial institution can have is limited by the local regulator. In practice, financial institutions will ensure this amount is below the maximum because there can be a double charge to capital in the case of large losses (the maximum is determined by reference to the amount of equity capital, so if the amount of equity capital reduces below the amount of hybrid regulatory capital, the excess of hybrid regulatory capital above that equity capital ceases to qualify as regulatory capital and is instead treated as an ordinary liability).

Most European insurers have issued hybrid financial instruments to the financial markets. Effectively, for insurers these are debt instruments, but due to regulatory constraints, these have subordinated features and are long-dated. From a commercial perspective these are highly attractive as the cost of capital on such instruments is substantially below the cost of equity (typically 4% to 7% instead of 12% to 15%). Whether issued externally, or used to finance subsidiaries intra-group, such instruments are part of the long-term capital structure of the relevant insurance companies. For these reasons (in addition to the reasons stated earlier), we believe that, regardless of whether a bottom-up or top-down approach is taken, these instruments should be out of scope.

Frequently, the tax treatment of such instruments has also been agreed on a long-term basis. Unwinding such instruments is difficult, and for market instruments (or instruments that are back to back intra-group transactions of market issued instruments), an unwinding is potentially expensive as any buyback before a call or maturity date generally requires a premium to be paid to the existing holder. If it were to be determined that the instruments should not be out of scope, given these practical difficulties we would recommend that existing instruments' current tax treatment be grandfathered.

## V. Repo transactions

We are concerned that the examples involving sale and repurchase arrangements (“repos”) in paragraphs 66-80 and paragraphs 262-271 of the Draft may create a presumption that repo transactions are only used for tax planning purposes. In fact, repos are secured lending arrangements entered into in the ordinary course of business on a daily basis by financial institutions for non-tax reasons.

The repos described in the Draft are used in structured transactions designed to achieve a BEPS result. However, the vast bulk of repos are done for financing purposes and do not generally raise hybridity concerns. Repos are very common in the financial services industry and are considered in all financial center jurisdictions to be secured loans that generate interest income and expense. Instead of a lender lending cash secured by collateral, repos involve the sale of securities together with an agreement for the seller to later buy the securities back. The repurchase price is usually greater than the original selling price with the difference effectively amounting to and treated as interest, sometimes called the *repo rate*. The party that originally buys the securities – i.e., provides the cash – is effectively the lender. The original seller – i.e., the party receiving the cash -- is effectively the borrower, using the securities transferred as collateral for a secured cash loan. In some jurisdictions, the tax law is unclear as to whether repos are sales transactions rather than a secured financing, with the result that there can be the possibility that a repo would be a hybrid transfer.

The OECD should explicitly acknowledge the fact that repos are a normal form of secured lending in the ordinary course of a financial services business and are not within the scope of the anti-hybrid rules unless they are part of a structured hybrid mismatch arrangement.

## VI. Definition of “dividend exemption” and “inclusion in ordinary income”

Clarification is needed as to whether the availability of an indirect foreign tax credit is considered equivalent to a dividend exemption.

The Draft seems to indicate that, if a dividend is received by a taxpayer who must include the dividend in ordinary income, the dividend is nevertheless not considered includible in ordinary income for purposes of the proposed hybrid financial instrument rules to the extent that the dividend carries an entitlement to an indirect foreign tax credit (see paragraphs 62, 94 and 108). However, in paragraph 85, it appears that a dividend exemption is *not* considered to be the same as other forms of double tax relief relating to dividends, although this could change (“[F]urther consideration could be given to whether a recommendation in respect of the dividend exemption should apply to other types of double tax relief granted for dividends…”). There are mixed messages here, causing confusion.

It is not at all clear how a rule equating entitlement to an indirect foreign tax credit with a dividend exemption to the extent that the credit was available would work in a case where (as in the United States and perhaps in other countries with worldwide systems) the taxpayer’s foreign tax credit is calculated not on an item-by-item basis but rather on the basis of a pool of foreign-source income blending numerous different items of income and related foreign tax expense, and the credit offsets only a portion of the taxpayer’s tax liability with respect to all of the taxable income of the taxpayer. In many circumstances, the theoretical availability of such a credit can be severely limited or

even non-existent if the foreign taxes are not sufficiently similar to the income tax levied in the home country.

## VII. Definition of "financial instrument"

The Draft also leaves the definition of "financial instrument" unclear. In paragraph 81, recommendation (d) provides:

> "The kinds of financial instruments caught by the rule should be left to domestic law but … should at least include anything that is treated as a debt or equity under the laws of the jurisdiction applying the rule. The definition should also include, where appropriate, arrangements that taxpayers use as alternatives to debt and equity."

This open-ended formulation may lead countries to adopt rules that are similarly open-ended in scope, creating uncertainty as to the application of the rules. We suggest that the OECD's recommendation should indicate the need for clarity regarding what is covered, along the lines of what is said in paragraph 105 ("The rule should define the arrangements that are within scope.") but with a reference to specificity.

# INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

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May 1, 2014

**VIA E-MAIL**

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**Re: Comments on Discussion Draft on BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Domestic Law Recommendations)**

Dear Mr. Pross:

The International Alliance for Principled Taxation (IAPT or Alliance) is a group of about two dozen major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, mining, telecommunications, oilfield services, transportation, luxury goods, computer technology, energy, pharmaceuticals, heavy equipment, entertainment, software, beverages, automotive, IT systems, publishing, electronics, and advertising. The group's purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally.

The Alliance appreciates the opportunity to provide input to the OECD and its Working Party No. 11 on Aggressive Tax Planning (WP11) with respect to the Discussion Draft released on March 19, 2014 on Recommendations for Domestic Laws with respect to BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (the Discussion Draft). Our comments on the Discussion Draft are set forth in Annex 1 to this letter. We are separately submitting comments on the Discussion Draft on Treaty Issues with respect to BEPS Action 2.

As you know, the IAPT submitted comments on Action 2 of the July 2013 BEPS Action Plan on October 16, 2013, and we include a copy of those comments as Annex 2 to this letter for reference.

Whilst we have been impressed with the quality of many aspects the analysis in the Discussion Draft, the IAPT has a number of significant concerns about the overly-broad scope, problematic design and potential operational complexity of the proposed domestic law ordering/linking rules. We also consider that, whatever package of recommended domestic law rules is finally agreed by the G20 in September 2014, this will inevitably need to be revisited in light of the work in 2015 on the other related Actions, in particular Actions 3, 4 and 5 relating to coherence. The IAPT stands ready to assist the OECD in this important work so that the final package of recommendations is for a set of coordinated, proportionate and targeted national measures that are workable for tax administrations and business alike.

There is a final important point to be made in this covering letter. We understand from recent public comments by the OECD that draft model tax legislation for the proposed domestic law ordering/linking rules is already at a relatively advanced stage. The IAPT strongly urges the OECD to release the draft for public comment sufficiently in advance of the meeting of the Committee of Fiscal Affairs in June for the draft to be properly considered and for comment to be provided. It is essential and good tax policy-making that business should have the opportunity to provide constructive comments on model draft legislation that could impact it significantly.

Once again, the Alliance appreciates the opportunity to comment on this important element of the BEPS project and stands ready to respond to any questions or to provide further input as the work of the OECD on this item continues.

Sincerely yours on behalf of the Alliance,

James E. MacLachlan
Baker & McKenzie LLP

Counsel to the Alliance

Annex 1: Comments on the March 19, 2014 Discussion Draft (Recommendations for Domestic Laws)
Annex 2: October 16, 2013 comments on Action Item 2 of the July 2013 BEPS Action Plan

# ANNEX 1

## INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

## COMMENTS ON MARCH 19, 2014 DISCUSSION DRAFT ON BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS (RECOMMENDATIONS FOR DOMESTIC LAW)

MAY 1, 2014

**IAPT Comments on OECD Public Discussion Draft on BEPS Action 2: Neutralise the Effect of Hybrid Mismatch Arrangements (Recommendations for Domestic Law)**

## 1. Introduction

1. Set out below are IAPT's comments on the OECD Discussion Draft in BEPS Action 2 regarding hybrid mismatch arrangements published on 19 March 2014 (the "DD"). We commend the rigour of analysis in many parts of the DD, particularly in relation to various types of hybrid mismatch arrangement. We also welcome the DD's recognition that the purpose of the proposed rules is not to collect additional tax revenue from covered structures and transactions.

2. We commend the DD's consideration of treaty issues as well as domestic law issues and the interaction between the two.

### *1.1 Points of agreement:*

3. IAPT generally agrees that the design principles set forth in Section II.2 of the DD on recommendations for domestic laws are clear and comprehensive.

4. We understand that countries have concerns with scenarios involving certain hybrid arrangements which can lead to BEPS, and we acknowledge the legitimacy of the OECD's effort to develop ways to counteract certain adverse tax consequences of these arrangements.

5. A common set of objective and targeted domestic "linking rules" are preferable, in principle, to purpose-based anti-avoidance rules (general or specific) or broad "subject to tax" clauses, provided that the rules conform to the design principles, in particular that the rules should be workable for taxpayers and keep their compliance costs to a minimum and should be easy for tax authorities to administer.

6. We agree with the conclusion in the DD on recommendations for domestic laws that harmonisation of domestic law tax treatment (including characterisation) of entities and financial instruments is not feasible and we note that such an approach could infringe on the ability of countries to make legitimate domestic tax policy choices.

### *1.2 Summary of Main Concerns*

7. The proposed linking rules potentially involve huge complexity for both taxpayers and tax authorities, with a consequent risk of unintended double taxation, as well as significant compliance and administrative costs. To minimise these adverse impacts, the rules should be developed in conjunction with and on same timetable (in 2015) as the other BEPS Actions also relating to coherence (i.e. Action 3 (strengthen CFC rules); Action 4 (limit base erosion via interest deductions); and Action 5 (counter harmful tax practices)).

8. Although the proposals appropriately recognize that not all arrangements involving double exemption (or exemption with deferral) are deliberately intended to shift profit between jurisdictions or

permanently erode the tax base of a jurisdiction, they do not yet provide a principled and certain way of defining and therefore carving out acceptable use of hybrid entities and financial instruments (including in but not limited to regulatory capital situations). In particular, the proposals do not attempt to distinguish between structures that have been deliberately engineered in order to achieve a hybrid mismatch and those where the mismatch arises as a result of a general difference in tax treatment in the relevant jurisdictions of an entity or instrument which is being used for good commercial reasons.

9. To be administrable, the linking rules should generally only operate in relation to hybrid mismatch arrangements involving controlled groups or otherwise unrelated parties acting in concert where it is practicable for the parties to exchange information needed to comply with the rules without undue cost. Hybrid financial instruments involving unrelated parties, in particular, generally present a low risk of BEPS; the mere fact that they result in asymmetries between different tax laws should not be a reason for treating them in the same way as abusive transactions. Any application to parties which are not members of controlled groups should be only in exceptional and well-defined circumstances, with appropriate taxpayer protections. This will be particularly important to ensure that commercial joint venture and project finance structures are not inappropriately caught by the new rules.

10. The DD does not consider whether there is a need for grandfathering rules to carve out hybrid mismatch arrangements which the taxpayer plainly did not intend to use to achieve BEPS (for example, existing structures in a target group which are inherited through acquisition) or at least transitional rules to enable the taxpayer to restructure the arrangements within a reasonable period and without an incremental tax cost. In our view, such rules will be critical to ensure that the linking rules to neutralise tax mismatches are properly targeted.

## 2. Comments on Recommendations for Domestic Laws

### *2.1 Objectives*

11. The objectives of the recommendations are clear insofar as they are intended to create a more symmetrical tax result and so to drive taxpayers towards less complicated/more transparent tax structuring. However, we are concerned that the proposed ordering rules may go further than needed to accomplish one of the important stated policy objectives of the recommendations which is to counteract only those arrangements which result in an erosion of the tax base of one or more jurisdictions where the arrangement is structured (see, for example, paragraphs 26 and 32 of the DD). A mismatch in tax treatment as a result of a hybrid element does not necessarily also result in BEPS. The DD seems to assume, however, that this will always be the case.

### *2.2 Scope and Design Principles*

12. The scope of proposed linking rules needs to be clarified and limited, particularly in relation to their application to arrangements between unrelated parties. In addition, it should be a basic principle that, where a deduction in one jurisdiction is matched by an inclusion in another jurisdiction, the linking rules will not be brought into play. In this regard, there are two particularly important points. First, CFC inclusions (in respect of income for which there is a corresponding deduction) should not be disregarded

in determining whether a D/NI scenario has arisen on the ground that it would be too complex to take them into account or indeed on any other ground; this would result in double taxation. Second, where an item of income is included (either directly in the hands of the payee or indirectly at parent company/investor level under CFC rules), the inclusion should count in determining whether a D/NI scenario has arisen notwithstanding that it is offset by any available relief, such as foreign tax credit relief, expense deductions or surplus tax losses. Other areas going to the scope of the proposed rules which require particular attention and further work include: (i) the extent to which individual countries should be free to define the scope of the transactions to be covered by the hybrid financial instruments rules and which returns are to be included as ordinary income; and (ii) ensuring that coordinated and simultaneous action is taken by countries which adopt the rules to ensure that they are applied with consistency and predictability.

13. As to the design principles, we have the comments set out below.

14. The statements in paragraph 26 of the DD (arrangement only in scope if it results in base erosion) and paragraph 28 (no need to establish which country has been base eroded) seem to be inconsistent. As noted in paragraph 11 above, the working premise of the DD seems to be that the mere existence of a tax mismatch due to hybridity means that BEPS occurs.

15. The rules should not be over-comprehensive and, in particular, should not generally capture commercial arrangements. They should generally be limited, in principle, to circular, contrived or otherwise artificial arrangements.

16. The IAPT certainly agrees that application of rules should not depend on exercise of administrative discretion by tax authorities. However, particularly where the parties to the arrangement are unrelated, the opportunity for a taxpayer defence is needed where arrangement is shown by the taxpayer, on the balance of probabilities and by reference to objective factors, to be effected for bona fide commercial reasons and does not have as a main purpose to avoid tax in relevant jurisdiction(s). In this regard, an advance ruling facility for the taxpayer defence would be helpful, again, particularly where the parties to the arrangement are not related.

17. To avoid double taxation anti-hybrid rules will also need to be closely coordinated with recommendations coming out of Actions 3, 4 and 5. Thus, Action 2 domestic law recommendations should not be finalised until September 2015 which means that any recommendations issued in September 2014 should be provisional only. Thus, as noted in paragraph 12 above, it needs to be clear that a D/NI scenario is not considered to exist in any case where there is an income inclusion (with a corresponding deduction), whether in the hands of the payee or under a CFC regime, and for this purpose administrable implementation rules will need to be developed to determine whether there has been such a inclusion and how this should be reported by the taxpayer. For example, in the United States, a Subpart F (i.e. CFC) inclusion would be reflected on Line 1 of Schedule 1 of the annual Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations), detailed on Line 38b of its Worksheet A, and substantiated in the related workpapers. In the United Kingdom, a CFC inclusion would be reported

for corporation tax self-assessment purposes on Form CT600B (2012) Version 2. This type of reporting should be sufficient evidence of a CFC inclusion for the purposes of disapplying the linking rules.

18. Real time coordination with output from Actions 3, 4 and 5 will also help ensure that anti-hybrid rules minimise disruption under existing domestic law; are clear and transparent; achieve consistency and flexibility; are workable for taxpayer; and easy for tax authorities to administer (Paragraphs 37-47 of the DD).

19. An important design principle is that the rules should achieve consistency among the jurisdictions which adopt them while providing the flexibility in their implementation (see paragraphs 40-42 of the DD). More work is needed to determine how best to accomplish these goals in a way which is compatible with domestic laws of the jurisdictions involved. For example, in some jurisdictions a multilateral instrument which has the effect of imposing tax (rather than merely eliminating double taxation) may require legislative approval. In these cases, a multilateral instrument which merely debars domestic anti-hybrid linking rules that do not conform to OECD recommendations may be feasible. In any event, the design of any multilateral instrument or other process to ensure cross-border consistency in the application of the linking rules should be coordinated with the work in 2015 under Action 15.

20. In order for the rules to be appropriately targeted and workable for taxpayers, as well as being easy for tax authorities to administer (see paragraph 43-47 of the DD), IAPT calls for the introduction of effective grandfathering or other transitional rules (see paragraph 10 above).

*2.3 Hybrid Financial Instruments & Transfers*

21. IAPT members are frequent issuers and holders of a wide range of instruments in the debt capital and derivatives markets, including convertible notes and other "structured" debt products. Although not (regulated) banks or insurance companies, most IAPT members have significant, often centralised, in-house finance and treasury operations which are active participants in those markets. We therefore strongly prefer a "bottom-up" approach which only targets hybrid financial instruments held between (a) related parties and (b) unrelated parties in clearly defined and limited circumstances. A "top-down" approach capable of applying to hybrid financial instruments held between unrelated parties, unless exclusions/carve-outs apply, is likely to involve significantly more compliance/administration costs and need for exchange of large amounts of information between issuer and holders, which may or may not prove feasible.

22. Our specific comments on proposed "bottom-up" approach are as follows:

23. The proposed 10% threshold for a related party test is far too low. We believe that a greater than 50% voting control threshold would normally be the only appropriate and administrable investor threshold for the purposes of operating the linking rules. It is generally only within controlled groups that the investor and issuer will have access to tax information relating to the other party so that it is able to comply with the rules. Where the parties are not members of a controlled group, the rules should only apply where the parties are acting in concert and able to access information relating to each other's

structures and relevant tax affairs. This will be particularly important in the context of large commercial joint ventures and project financing structures where there are multiple parties who may be said to be acting in concert but where some parties may be unwilling and/or unable to provide relevant information to the other parties (and cannot be compelled by them to do so) but where the structure includes hybrid financial instruments for sound commercial reasons. For example, in large projects with multiple investors that have different credit ratings there will often be a mix of bank and other lenders looking to "cherry pick" those investors with the strongest credit rating. To prevent this and achieve true limited recourse to project assets, complex financing structures involving the use of subordinated debt, preferred shares and other non-standard financial instruments will frequently be implemented. These may well be hybrid instruments that give rise to tax mismatches under relevant domestic laws that cannot be monitored by the parties, but as a matter of principle and common sense the anti-hybrid counter-measures should not come into play in this type of situation which does not, and is not intended to, achieve BEPS.

24. We question the need for both "acting in concert" and "structured arrangements" tests where parties are unrelated. We expect that parties to a structured arrangement (as defined) would usually be acting in concert.

25. A well-defined acting in concert test is considered to be preferable to a structured arrangements test. It is more objective and more easily drafted using jurisdiction neutral terminology. Quite apart from the challenge of defining what a "structured arrangement" is, there is real risk that there could be widely differing interpretation and application of the rule across jurisdictions.

26. If there is to be a structured arrangements test (independent of an acting in concert test), however, it should be coordinated with the definition of "aggressive tax planning arrangements" under proposed mandatory disclosure rules for 2015 (Action 12).

27. There should be no circumstances in which the proposed ordering rules should apply to investors but not issuers (or vice versa) in the case of transactions between independent parties unless they are acting in concert.

28. None of the members of the IAPT is a bank, insurance company other type of group which is subject to capital adequacy/prudential regulation. We therefore do not comment on the questions raised by the DD in relation to hybrid regulatory capital.

*2.4 Hybrid Entity Payments*

29. The rules should, as with hybrid financial instruments, normally only cover mismatches arising between members of a controlled group applying a 50% threshold. Where otherwise unrelated parties are involved, they should only apply where the parties are acting in concert and under conditions where the parties are able to access relevant information about hybrid entities in their structures. A structured arrangements test is potentially more complex and less capable of jurisdiction-neutral definition.

30. The operation of the proposed primary and secondary (defensive) rules in relation to hybrid entity payments arising in the example hybrid mismatch structures cited in the DD is relatively clear at a

conceptual level. However, the "devil" will, as with the proposals for hybrid financial instruments and imported mismatches/reverse hybrids, be in their detailed application in the context of a wide variety of domestic laws and tax administration practices. A multilateral instrument or process to ensure a consistent interpretation and application would seem necessary. However, this will not be sufficient to deal with countries that do not adopt the instrument or process but introduce the proposed rules.

31. It is not clear what type of hybrid entity payment structure paragraph 196 of the DD is aimed at. This states that the investor jurisdiction should be able to apply the primary rule (to disallow relief for hybrid entity loss) irrespective of investor's ownership percentage.

*2.5 Imported Mismatches & Reverse Hybrids*

32. Any primary rule (inclusion in investor jurisdiction) which involves new or amended domestic CFC or other similar anti-deferral / abuse rules - as well as enhanced information reporting in the intermediary jurisdiction - needs to be coordinated with recommendations to strengthen CFC rules to be issued in 2015 (Action 3).

33. To minimise risk of creating double taxation, a defensive rule (in the payer jurisdiction) under which relief is denied for a payment made under an imported mismatch arrangement which is deductible but not included as income (in the intermediary or investor jurisdiction) should be coordinated with recommendations to limit base erosion via interest deductions to be issued in 2015 (Action 4).

34. We agree that the scope of linking rules for imported mismatches and reverse hybrids should be limited to controlled groups. Any extension to structured arrangements between otherwise uncontrolled parties will need to be in clearly defined/limited circumstances and should be considered in 2015 along with Action 4 and Action 12 (require disclosure of aggressive tax planning arrangements).

35. Particularly (but not exclusively) in the context of imported mismatches and reverse hybrids, it should be clear that the anti-hybrid counter-measures will only deny a deduction in the payer jurisdiction (as a defensive rule) to the extent that the expense is clearly attributable to a hybrid financial instrument which gives rise to a corresponding non-inclusion outcome. Otherwise a risk of double taxation arises. As a corollary, to the extent that the expense is attributable to non-hybrid debt, it should in principle be fully allowable, subject only to any general interest relief limitation rule that would normally apply.

# ANNEX 2

## INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

## COMMENTS ON ACTION ITEM 2 OF THE JULY 19, 2013 BEPS ACTION PLAN

## OCTOBER 16, 2013

**IAPT Comments on BEPS Action #2 (Hybrid mismatch arrangements)**

***Action 2 - Neutralise the effects of hybrid mismatch arrangements***

*Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) 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); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.*

We understand that countries have concerns with BEPS and scenarios involving hybrid mismatch arrangements, and we acknowledge the legitimacy of the OECD's effort to develop ways to counteract certain adverse consequences of these arrangements. We recognise and acknowledge that hybrid mismatch arrangements may in certain situations create problems from the point of view of economic efficiency and fairness. Furthermore, we agree that the OECD is the right body to address this issue, as it has a solid expertise in international taxation and a policy of consensus.

Action item #2 clearly follows and builds on the preliminary work set out in the OECD's March 2012 report, "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues".[1] The introductory text to action item #2 refers to the various types of hybrid mismatches which had also been referred to in the 2012 report, and it alludes to the policy issues which arise as a result of hybrid mismatches.[2]

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[1] Available at http://www.oecd.org/ctp/aggressive/hybridmismatcharrangementstaxpolicyandcomplianceissues.htm.

[2] Similar concerns have been the subject of section 4.1.1 of the European Commission's December 6, 2012 "Action plan to strengthen the fight against tax fraud and tax evasion", COM(2012)722, available at

We note that the OECD intends to develop solutions in the form of both changes to the OECD Model Tax Convention and recommendations regarding the design of domestic law rules. We agree that both types of measures would be necessary to address the variety of hybrid mismatch arrangements identified in the Action Plan, since the double non-taxation scenarios arising from hybrid mismatch arrangements are sometimes attributable to a combination of domestic law and treaty rules and sometimes to domestic law rules alone. That being said, certain considerations should be taken into account in designing either form of solution.

With regard to possible anti-hybrid provisions in treaties, the IAPT believes it is important for such provisions to be appropriately targeted to unintended double taxation which results from specific hybrid features, so as not to deny treaty benefits in cases where such a denial would not be justified. For example, the IAPT does not believe it would be appropriate to include in the Model a broad "subject to tax" clause of the type proposed by the European Commission.[3] One cannot automatically assume that a transaction that results in double exemption (or exemption plus deferral) is necessarily contrary to the intent of the relevant treaty. While the general policy of treaties is to avoid double taxation and not to create opportunities for double exemption, it is also the case that double exemption (or exemption plus deferral) can legitimately arise in many different circumstances under treaties. Examples of such circumstances include:

1. Payments that are exempt in the residence country under a territorial system of taxation.[4]
2. Payments that are exempt in the residence country under a participation exemption regime.[5]
3. Payments that are exempt in the residence country because derived by a tax exempt entity there (e.g., a charity, pension fund, or governmental entity, or by a collective investment vehicle).

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http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/com_2012_722_en.pdf, the Commission's December 6, 2012 Recommendation on Aggressive Tax Planning, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/c_2012_8806_en.pdf, and the European Council's Conclusions of May 22, 2013, EUCO 75/1/13/REV 1, available at http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/137197.pdf.

[3] In its December 2012 Recommendation on aggressive tax planning, the Commission urged EU Member States to include in their tax treaties the following provision: "Where this Convention provides that an item of income shall be taxable only in one of the contracting States or that it may be taxed in one of the contracting States, the other contracting State shall be precluded from taxing such item only if this item is subject to tax in the first contracting State."

[4] For example, it is customary to give relief from the source state withholding tax on direct investment dividends from a subsidiary to a parent corporation, even if the parent corporation's state of residence exempts those dividends under its territorial system of relieving international double taxation.

[5] For example, it is equally customary to give relief from the source state withholding tax on direct investment dividends, even if the parent corporation's state of residence exempts those dividends under a participation regime for alleviating double corporate taxation, whether on an international or domestic basis.

4. Payments that are exempt in the residence country because eligible for favorable treatment under a tax holiday or other targeted incentive provision there.
5. Payments that are not taxed in the residence country because the recipient has offsetting foreign tax credits.
6. Amounts that are not currently taxed in the residence country because the recipient has a net operating loss.
7. Amounts that are not currently taxed in the residence country because the recipient is subject to tax consolidation there with other affiliates.
8. Amounts that are not currently taxed in the residence country because not considered to have been triggered there under that country's nonrecognition principles.

Numerous other examples of such circumstances could be cited. For good reason, tax treaties generally have not been designed to test for actual double taxation on an income-item-by-income-item or transaction-by-transaction basis. Instead, they assume that a sufficient risk of double taxation exists when income is paid from one country to a tax resident of the other country that a source country tax reduction is justified. They do not then inquire into the manner in which the residence country chooses to exercise its taxing jurisdiction over that income in every particular case.

Indeed, the OECD, in considering appropriate treaty formulations of anti-abuse rules, specifically rejected a "subject to tax" approach that would have required a risk of actual current double taxation on any item of income before a treaty benefit could apply.[6] Thus, the policy that treaties are not designed to create opportunities for double exemption must be balanced against the policy that source country treaty benefits to a resident of another country are not designed to be conditioned on an item-by-item or transaction-by-transaction finding of the possibility of actual double taxation.

Of course, when treaty partners view certain kinds of double exemption possibilities as reaching unacceptable levels, such as may be the case for the types of hybrid mismatch arrangements described in the Action Plan, they can and often do deal with that quite legitimately by including targeted anti-abuse provisions in their treaties. The IAPT simply wishes to stress that not all double exemption (or exemption plus deferral) scenarios which arise from different treatment of an item or entity under the two countries' laws warrant a denial of treaty benefits, so it is important to draft such anti-abuse provisions carefully.

The IAPT also notes that a variety of different provisions have appeared in treaty practice over the past decade or more, aimed at avoiding double non-taxation in hybrid mismatch arrangements. For example, the United States alone has used at least six different formulations of its provision relating to fiscally transparent entities in its treaty practice in the past 10 years.[7] The experience of the business community

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[6] OECD, "Double Taxation Conventions and the Use of Conduit Companies", (1986).

[7] See, e.g., the U.S. treaties or protocols with Poland (2013), Belgium (2006), Sweden (2005), France (2009), Canada (2007), and Japan (2003).

is that such formulations, including the one based on the 2006 U.S. Model Treaty which is used most frequently, all pose issues of interpretation for which clear guidance would be desirable. These types of provisions tend to present significant drafting challenges, due in part to the variety of situations they are intended to address. The IAPT therefore encourages the OECD, if it intends to introduce new provisions into the OECD Model to address hybrid mismatch situations, to issue such proposed changes in discussion draft form and to provide an adequate opportunity for comment so that such issues of interpretation can be adequately addressed.

It is certainly the case that the majority of double non-taxation situations attributable to hybrid mismatch arrangements arise from the interplay of countries' purely domestic law and do not depend upon treaties for their existence. It therefore makes sense to consider domestic law solutions to those hybrid mismatches. The IAPT notes that the 2012 report on hybrid mismatches concludes that specific and targeted "linking" legislation, which ties the availability of benefits in one country to the non-use of benefits in another country, holds significant potential to address hybrid mismatches and has produced positive experience for the countries that have tried it.[8]

While the IAPT does not dispute that such linking legislation has the potential to significantly reduce double non-taxation situations attributable to hybrid mismatches, it does wish to sound a note of caution about the need to design such legislation carefully in order to avoid the possibility that attempts to stamp out instances of double non-taxation lead systematically to double taxation. The example of the U.S. and U.K. rules on the cross-border use of losses may help to illustrate this point. The U.S. rules on so-called "dual consolidated losses" deny the ability to use a loss incurred by a dual resident company (or a separate unit of a domestic company) to offset the income of a domestic affiliate where that same loss can also be used to offset the income of a foreign company for foreign tax purposes. The United Kingdom has somewhat similar rules, including rules developed after the 2005 ECJ decision in the *Marks & Spencer plc v. Halsey* case (C-446/03), when the ECJ ruled the United Kingdom had to allow group loss relief on losses arising from EU subsidiaries when there were no possibilities of using the loss in the subsidiary State.

Both sets of rules have led to substantial interpretive disputes about how to determine whether a foreign tax benefit could or would be obtained with respect to the loss in question. The U.S. rules have undergone a series of amendments in order to reduce the complexity and initially overly punitive application of that test.[9] The U.K. rules have been the subject of litigation in both the United Kingdom and the ECJ on whether they were drawn too restrictively so as to systematically preclude tax relief

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[8] That report references, for example, the U.S. dual consolidated loss rules of Section 1503(d) of the Internal Revenue Code and the U.K. group relief loss limitation rule of Sections 106 and 107 of the Corporation Tax Act 2010..

[9] See, e.g., Greenwald and Fuselier, "The Remarkable Taxpayer-Friendly Evolution of the DCL Regime", 54 Tax Notes Int'l 161 (Apr. 13, 2009), 2009 WTD 73-11, for a description of the changes made.

anywhere for real commercial losses.[10] The issues relate to questions such as when the determination is made of whether a foreign benefit is or will be possible, what facts are considered or assumed for purposes of making that determination, what procedural hurdles the taxpayer needs to clear to obtain the domestic benefit, what the effect is of foreign legislation which basically mirrors the domestic rule, etc. In short, the experience of business has been that such linking legislation can be extraordinarily complex to apply in practice, and that it must be pragmatically and thoughtfully designed in order to avoid a systematic shift to double taxation. Here, too, the IAPT respectfully suggests that the OECD could benefit from consultation with business if it wishes to avoid some of the pitfalls that have characterized early efforts at designing linking legislation.

One point worth noting with respect to hybrid mismatch effects under both treaties and domestic law is that many hybrid mismatches produce effects which amount to timing mismatches only. In such cases, a permanent denial of benefits in one country on the grounds that there is no current detriment in the other country could result in effective double taxation when the mismatch reverses itself in that other country. There is obviously a policy decision to be made as to whether anti-hybrid rules should be designed to apply to such timing mismatch hybrid situations, or whether that is disproportionate to the problem. Even if policymakers believe anti-hybrid rules should apply in such cases, an appropriate approach could be to have those rules defer the benefits in the first country until the hybrid effect is reversed in the second country, rather than denying benefits in the first country altogether. The IAPT notes, however, that taxpayers can face complex tracking challenges if they are forced to demonstrate the timing of a later year detriment in the second country in order to claim the original benefit in the first country. We therefore urge the OECD to weigh carefully the justification for applying anti-hybrid rules to timing mismatch situations against the risk of double taxation that could create.

The IAPT further notes that the potential complexity of anti-hybrid rules can be mitigated from the taxpayer's perspective if the relevant regime includes both thorough public guidance on the tax administration's approach to applying the anti-hybrid regime and a clearance mechanism to provide certainty in individual cases. Also, rules which are not drafted to cause an automatic denial of benefits, but which give the taxpayer an opportunity to defend its claim to benefits, provide welcome flexibility to what could otherwise be an overly rigid regime. The IAPT notes that these kinds of features can be found in the U.K.'s anti-arbitrage regime.

Action item #2 refers to the possibility that guidance on coordination or tie-breaker rules may be developed to address cases where more than one country seeks to apply such rules to a transaction or structure. If implementation of the basic recommendations to be developed under action item #2 leads to a proliferation of domestic linking legislation in countries across the world, the need for such a workable

[10] See, e.g., HM Revenue & Customs v. Marks & Spencer plc; [2013] UKSC 30 (May 22, 2013); Commission v. United Kingdom, C-172/13 (action brought in ECJ on April 5, 2013).

tie-breaker solution to avoid double denials of benefits (and hence double taxation) should not be underestimated. The IAPT notes that there is already precedent in both domestic rules and international practice for allowing the taxpayer to elect the jurisdiction where the benefit is to be claimed,[11] and it encourages the OECD to develop guidance that follows that general pragmatic approach.

Finally we note that challenges could arise from requirements to disclose all hybrid arrangements, including the potential difficulty of identifying the relevant hybrids in the first place. Here again, experience has shown that while many hybrid arrangements result from conscious planning on the part of taxpayers, others arise more naturally as a result of the ever-present differences between national tax systems, and taxpayers should not be penalized if they do not always immediately recognize the existence of a hybrid possibility. Moreover, experience has also shown that there can often be good faith disagreements about whether a particular situation fits within the relevant hybrid arrangement definition, which also highlights the need for reasonable rules surrounding any reporting requirements.

[11] See, e.g., the so-called "domestic use election" under the U.S. dual consolidated loss rules in Treas. Reg. section 1.1503-2(g)(2); U.S.-U.K. competent authority agreement of October 6, 2006.

# INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

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May 1, 2014

**VIA E-MAIL**

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**Re: Comments on Discussion Draft on BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)**

Dear Ms. de Ruiter:

The International Alliance for Principled Taxation (IAPT or Alliance) is a group of about two dozen major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, mining, telecommunications, oilfield services, transportation, luxury goods, computer technology, energy, pharmaceuticals, heavy equipment, entertainment, software, beverages, automotive, IT systems, publishing, electronics, and advertising. The group's purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally.

The Alliance appreciates the opportunity to provide input to the OECD and its Working Party No. 1 on Tax Conventions and Related Issues (WP1) with respect to the Discussion Draft released on March 19, 2014 on Treaty Issuesunder BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (the Discussion Draft). Our comments on the Discussion Draft are set forth in Annex 1 to this letter. We are separately submitting comments on the Discussion Draft on Domestic Law Recommendations with respect to BEPS Action 2.

As you know, the IAPT submitted comments on Action 2 of the July 2013 BEPS Action Plan on October 16, 2013, and we include a copy of those comments as Annex 2 to this letter for reference.

In our comments, we identify our areas of support for and concern with the analysis put forth in the Discussion Draft. In short, we agree that consistent application of the principles of the 1999 OECD Partnership Report to fiscally transparent entities, including amounts derived through such entities, would be beneficial in many respects and believe there is much room for improvement in practice in this area. Aspects of the Discussion Draft's specific proposals could, we believe, benefit from additional consideration to address potential, presumably unintended, double taxation and discriminatory effects. For similar reasons, we have suggested some modifications to the proposals relating to dual residence and cases of differing domestic law and treaty residence. Finally, in addition to considering the treaty implications of any domestic law anti-hybrid measure, we believe that it will also be important to coordinate any treaty and domestic law measures with the work on the BEPS Actions on Interest Deductibility, CFCs, and Disclosure, as well as that on Treaty Abuse. This will be critical to avoid inefficiency and duplication and to ensure the application of properly targeted measures, and it is not apparent from the Discussion Draft that such coordination is occurring.

Once again, the Alliance appreciates the opportunity to comment on this important element of the BEPS project and stands ready to respond to any questions or to provide further input as the work of the OECD on this item continues.

Sincerely yours on behalf of the Alliance,

Carol A. Dunahoo
Baker & McKenzie LLP

Counsel to the Alliance

Annex 1: Comments on the March 19, 2014 Discussion Draft (Treaty Issues)
Annex 2: October 16, 2013 comments on Action Item 2 of the July 2013 BEPS Action Plan

# ANNEX 1

## INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

## COMMENTS ON MARCH 19, 2014 DISCUSSION DRAFT ON BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS (TREATY ISSUES)

MAY 1, 2014

# IAPT Comments on the March 19, 2014 Discussion Draft on BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)

## 1. Introduction

1. The IAPT would like to commend WP1 on the Discussion Draft identifying potential treaty measures and issues (the Discussion Draft) that will need to be addressed in connection with both the changes called for by BEPS Action 2 on dual resident entities and the domestic law recommendations developed by WP11 on hybrid mismatch arrangements. The Discussion Draft succinctly identifies and discusses a series of important treaty issues, and we agree with many of its conclusions and recommendations.

2. There are a number of points on which we fully concur with the Discussion Draft. These include the following:

- That it is important to evaluate the treaty implications of any proposed domestic law changes to address hybrid mismatch arrangements and carefully consider the interaction between the two;
- That aspects of the work being done on BEPS Action 6 (Preventing Treaty Abuse) will play an important role in achieving the goal of Action 2 of ensuring "that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly"; and
- That consistent application of the principles of the 1999 OECD Partnership Report to fiscally transparent entities would be beneficial in many respects.

3. We also have, however, certain concerns about various aspects of the Discussion Draft, which we discuss in more detail below. Our primary concerns can be summarized as follows:

- To avoid overlapping and unnecessary measures, the treaty proposals need to be coordinated with other BEPS measures under consideration, particularly the work on Interest Deductibility, CFCs, and Disclosure, in addition to the work on the Treaty Abuse issues to which the Discussion Draft refers.
- Like the domestic law proposals, the treaty proposals present serious challenges from the point of view of administrability and compliance, as shown by the experience under some such provisions already included in treaties. Treaty provisions governing the treatment of income received by or through fiscally transparent entities will need to be drafted very carefully to provide certainty, ensure consistent application, and avoid the inappropriate denial of treaty benefits.
- More effective measures are needed to ensure that cases of dual resident entities are, in fact, resolved, as such cases do arise in unplanned scenarios in which there is no policy rationale or clear legal basis, at least under EU law, for denying treaty benefits.

- Potential concerns regarding the application of treaty non-discrimination and relief from double taxation provisions should be given further thought.

**2. Comments on the Dual Resident Entity Proposals**

4. As noted in the IAPT's April 9 comments on the Discussion Draft's proposal to amend Article 4(3) of the OECD Model Tax Convention to allow the competent authorities to resolve cases of dual resident entities on a case-by-case basis, cases of dual residence can and do arise outside the context of tax planning. For example, it is common for regional management based in one country to constitute a majority of the members of the boards of group companies created under the laws of other countries in the region. If board decisions are taken in meetings in the first country or by circulated resolutions, companies may become dual residents of the first country and the country in which they were created. However, such situations arise not for tax planning purposes, but for reasons of operational efficiency and because it can be difficult to find a sufficient number of appropriate local directors. These situations often arise unintentionally and without the knowledge of the tax department and should not be presumed objectionable.

5. The proposed case-by-case approach would create an unnecessary burden for the competent authorities and an unacceptable level of uncertainty for taxpayers, as treaty benefits would be denied in the absence of a competent authority agreement. A failure to provide adequate access to treaty benefits in such cases would be inappropriate and could also raise questions within the EU regarding violations of the freedom of establishment.

6. We suggest that the OECD explicitly acknowledge this fact and, accordingly, clarify that either: (i) a request for a competent authority resolution pursuant to the proposed Article 4 language and Article 25(1) will be eligible for arbitration under Article 25(5); or (ii) the competent authorities shall endeavor to resolve the issue with a specified period after the request is made, not to exceed one year.

7. We also have some concerns regarding the proposed domestic law provision under which an entity that is considered a resident of another State under a treaty would automatically be deemed not to be a resident under domestic law. While we can appreciate that governments may wish to take steps to prevent an entity from claiming both treaty benefits as a resident of one country and domestic law benefits as a resident of another country, we submit that it would be inappropriate to compel non-resident status where the entity is not claiming treaty benefits. An exception should be provided for cases such as this where the taxpayer is not benefiting from its differing residence status under domestic law and treaty provisions. In addition, it should be confirmed that any such forced change of domestic law residence status will not have collateral consequences, such as deemed outbound reorganization treatment.

**3. Comments on the Use of Transparent Entities to Obtain Treaty Benefits Unduly**

8. The goal of ensuring the application of the approach set forth in the 1999 OECD Partnership Report and the Commentary seems appropriate as a general matter of policy, both for partnerships and for other entities that are transparent in whole or in part.

9. It would be very helpful to ensure that this approach will be applied consistently across jurisdictions so that treaty benefits are, in fact, allowed for income derived by or through transparent entities where appropriate under the principles of that guidance, as this is not always the case in practice at present[1] and a number of countries, including France, Germany, the Netherlands, Portugal, and Switzerland reserved on various aspects of the Partnership Report at the time of its adoption.

10. However, the design and application of treaty provisions to implement the Partnership Report provisions is likely to prove complex. Experience shows that treaty and Commentary provisions to apply the principles of the Partnership Report will need to be drafted very carefully to provide certainty, ensure consistent application, and avoid the inappropriate denial of treaty benefits.

11. A variety of treaty provisions have been used for this purpose, especially over the past decade, with at least six formulations appearing in U.S. treaties alone.[2] Most, but not all, of these U.S. formulations are similar to the 2006 U.S. Model Convention,[3] which is in turn very similar in approach to, although somewhat narrower than, the text proposed by the Discussion Draft for addition as paragraph 2 of Article 1 of the OECD Model Convention. These provisions have raised significant interpretive issues[4] and prompted a number of controversies. Indeed, the U.S. Senate Committee on Foreign Relations raised concerns—still unresolved—regarding overbreadth[5] when such provisions were considered for addition by the 2007 Protocol to the U.S.-Canada Treaty, as paragraphs 6 and 7 of Article IV:

> As noted by the Joint Committee on Taxation in its explanation of the Protocol, commentators have raised a question as to whether subparagraph 7(b) is too broad, because it could prevent legitimate business structures that are not engaging in potentially abusive transactions from taking

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[1] We note that it is widely anticipated that an imminent International Fiscal Association General Report on the Qualification of Taxable Entities and Treaty Protection will conclude, based on extensive local expert analyses, that many countries have not yet fully implemented the principles of the Partnership Report in their treaty practices.

[2] See, e.g., the U.S. treaties or protocols with Poland (2013), Belgium (2006), Sweden (2005), France (2009), Canada (2007), and Japan (2003).

[3] Paragraph 6 of Article 1 of the 2006 U.S. Model Convention provides as follows:

> An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.

[4] See, e.g., New York State Bar Association Tax Section Report on the Model Income Tax Convention Released by the Treasury on November 15, 2006 (Apr. 11, 2007); letter from Tax Executives Institute, Inc. to Eric Solomon, U.S. Treasury Assistant Secretary (Tax Policy) regarding Fifth U.S.-Canada Protocol: Technical Explanation and Approval (Dec. 19, 2007); Philip D. Morrison, Anti-Hybrid Provisions of New U.S.-Canada Protocol, 36 TAX MGMT INTERN'L J. 660 (Dec, 14, 2007).

[5] See Senate Exec. Rpt. 110-15 on Protocol Amending 1980 Tax Convention with Canada, at 5 (110th Cong., 2d Sess.) (Sept. 11, 2008).

advantage of benefits that would otherwise be available to them under the treaty. The Treasury Department, in response to questions from the committee, noted as follows regarding subparagraph 7(b):

> Subparagraph 7(b) essentially denies benefits in cases in which the residence country treats a payment differently than the source country and other conditions are met. The rule is broader than an analogous rule in Treasury regulations issued pursuant to section 894 of the Internal Revenue Code. The Treasury Department is aware that the scope of subparagraph 7(b) is potentially overbroad, especially in the case of non-deductible payments. The Treasury Department has been discussing, and will continue to discuss with Canada, whether to address this issue. The Treasury Department does not contemplate incorporating such a rule in future tax treaties.

12. The proposed Article 1(2) text addresses some of the uncertainties and difficulties posed by some U.S. treaty formulations. However, given the practical experience to date with such formulations and the significant drafting challenges involved in addressing a range of situations, it will be important for the OECD to carefully consider comments regarding any interpretive issues or anomalous or overbroad effects of the proposed text., so that such issues of interpretation can be adequately addressed.

13. For example, it is possible that questions could arise regarding the application of the proposed rule to "arrangements" as well as "entities" and the proposed Commentary paragraph 26.8 indicating that the term "arrangements" is intended to reach situations that do not have legal personality and do not involve a "person" within the meaning of Article 3. In such scenarios, there would appear to be some question as to how the intent of having the proposed provision apply in a balanced way both to allow and to deny treaty benefits, as appropriate, could be realized. There may, for example, be issues in such scenarios regarding the availability of relief from double taxation under the current provisions of Articles 23A and 23B, as those provisions apply to residents, which are required under Article 3 to be persons.

14. As another example, it may be necessary to craft special limitations on benefits provisions to ensure that the non-transparent portion of an entity that is partially fiscally transparent will continue, as intended by proposed Commentary paragraph 26.11, to receive treaty benefits. This is especially important if standard base erosion and ownership tests are included.

15. It would be helpful to confirm explicitly that, where income paid by a person in a State is treated as the income of residents of a second State but is derived through a fiscally transparent entity established in a third State, the first State should grant any benefits available under its treaty with the second State. This is the implication of paragraph 26.8 of the Commentary on Article 1 proposed by the Discussion Draft, but this approach is rejected in practice in a number of countries that consider only their treaties with the third State as potentially applicable in such cases.

## 4. Comments on Interaction Between Treaties and Domestic Laws

### *4.1 Discrimination Issues*

16. The IAPT appreciates the attention given to potential issues under treaty non-discrimination provisions. We would recommend, however, that further consideration be given to the query raised by WP11 regarding the potential imposition of tax under the recommended domestic law provisions on persons without a residence or a PE in the jurisdiction.

17. The Discussion Draft concludes that such taxation does not appear to be contemplated and that the existing provisions of Articles 23A and 23B should, therefore, operate to eliminate double taxation. However, we are concerned that it may not be clear that this approach will provide a complete solution in all cases. For example, if a resident of State B (BCo) were engaged in business in State A, but not through a PE, and were the payee on a hybrid instrument issued by a resident of State C, the State A anti-hybrid domestic law provisions might require BCo's State A trade or business to include in income a payment on the instrument. The treaty between State A and State B should apply to prevent State A from taxing that forced inclusion where it is not attributable to a State A PE, but this limitation would not apply if the inclusion were not characterized as business profits. Thus, there is a risk of State A taxation in countries where the domestic law rules for determining the scope of net-basis taxation over a nonresident's income are not coordinated with standard treaty PE and profit attribution rules and where an OECD-style Other Income article is not included. Further consideration should be given to addressing this and other such cases by providing affirmative guidance regarding the characterization of forced inclusions, rather than referring simply to "ordinary income" treatment.

### *4.2 Unrelieved Double Taxation Issues*

18. The approaches proposed by the Discussion Draft could also create situations in which a legitimate deduction is denied in all jurisdictions involved, because they treat deductions as a matter of domestic law and urge the introduction of new domestic laws to deny deductions in many certain cases. It is not clear that this situation would be addressed by existing treaty provisions regarding relief from double taxation.

19. This would create double taxation, contrary to the purpose of the convention, and could prove inconsistent with the Non-Discrimination Articles of many treaties. Further thought should be given to how to prevent the recommendations from resulting in the systematic, potentially discriminatory creation of unrelieved double taxation.

### *4.3 Tax Credit Limitations*

20. We are also concerned by the tax compliance and administration burdens associated with the type of per-item and per-country approach proposed in paragraph 22 of the Discussion Draft to limit cross-crediting under treaties. Both per-item and per-country limitations on foreign tax credits create significant burdens, and the combination of the two could well prove unadministrable for both taxpayers and tax administrations.

# ANNEX 2

## INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

## COMMENTS ON ACTION ITEM 2 OF THE JULY 19, 2013 BEPS ACTION PLAN

## OCTOBER 16, 2013

**IAPT Comments on BEPS Action #2 (Hybrid mismatch arrangements)**

***Action 2 - Neutralise the effects of hybrid mismatch arrangements***

*Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) 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); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.*

We understand that countries have concerns with BEPS and scenarios involving hybrid mismatch arrangements, and we acknowledge the legitimacy of the OECD's effort to develop ways to counteract certain adverse consequences of these arrangements. We recognise and acknowledge that hybrid mismatch arrangements may in certain situations create problems from the point of view of economic efficiency and fairness. Furthermore, we agree that the OECD is the right body to address this issue, as it has a solid expertise in international taxation and a policy of consensus.

Action item #2 clearly follows and builds on the preliminary work set out in the OECD's March 2012 report, "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues".[6] The introductory text to action item #2 refers to the various types of hybrid mismatches which had also been referred to in the 2012 report, and it alludes to the policy issues which arise as a result of hybrid mismatches.[7]

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[6] Available at http://www.oecd.org/ctp/aggressive/hybridmismatcharrangementstaxpolicyandcomplianceissues.htm.

[7] Similar concerns have been the subject of section 4.1.1 of the European Commission's December 6, 2012 "Action plan to strengthen the fight against tax fraud and tax evasion", COM(2012)722, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/com_2012_722_en.pdf, the Commission's December 6, 2012 Recommendation on Aggressive Tax Planning, available at

We note that the OECD intends to develop solutions in the form of both changes to the OECD Model Tax Convention and recommendations regarding the design of domestic law rules. We agree that both types of measures would be necessary to address the variety of hybrid mismatch arrangements identified in the Action Plan, since the double non-taxation scenarios arising from hybrid mismatch arrangements are sometimes attributable to a combination of domestic law and treaty rules and sometimes to domestic law rules alone. That being said, certain considerations should be taken into account in designing either form of solution.

With regard to possible anti-hybrid provisions in treaties, the IAPT believes it is important for such provisions to be appropriately targeted to unintended double taxation which results from specific hybrid features, so as not to deny treaty benefits in cases where such a denial would not be justified. For example, the IAPT does not believe it would be appropriate to include in the Model a broad "subject to tax" clause of the type proposed by the European Commission.[8] One cannot automatically assume that a transaction that results in double exemption (or exemption plus deferral) is necessarily contrary to the intent of the relevant treaty. While the general policy of treaties is to avoid double taxation and not to create opportunities for double exemption, it is also the case that double exemption (or exemption plus deferral) can legitimately arise in many different circumstances under treaties. Examples of such circumstances include:

1. Payments that are exempt in the residence country under a territorial system of taxation.[9]
2. Payments that are exempt in the residence country under a participation exemption regime.[10]
3. Payments that are exempt in the residence country because derived by a tax exempt entity there (e.g., a charity, pension fund, or governmental entity, or by a collective investment vehicle).
4. Payments that are exempt in the residence country because eligible for favorable treatment under a tax holiday or other targeted incentive provision there.

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http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/c_2012_8806_en.pdf, and the European Council's Conclusions of May 22, 2013, EUCO 75/1/13/REV 1, available at http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/137197.pdf.

[8] In its December 2012 Recommendation on aggressive tax planning, the Commission urged EU Member States to include in their tax treaties the following provision: "Where this Convention provides that an item of income shall be taxable only in one of the contracting States or that it may be taxed in one of the contracting States, the other contracting State shall be precluded from taxing such item only if this item is subject to tax in the first contracting State."

[9] For example, it is customary to give relief from the source state withholding tax on direct investment dividends from a subsidiary to a parent corporation, even if the parent corporation's state of residence exempts those dividends under its territorial system of relieving international double taxation.

[10] For example, it is equally customary to give relief from the source state withholding tax on direct investment dividends, even if the parent corporation's state of residence exempts those dividends under a participation regime for alleviating double corporate taxation, whether on an international or domestic basis.

5. Payments that are not taxed in the residence country because the recipient has offsetting foreign tax credits.
6. Amounts that are not currently taxed in the residence country because the recipient has a net operating loss.
7. Amounts that are not currently taxed in the residence country because the recipient is subject to tax consolidation there with other affiliates.
8. Amounts that are not currently taxed in the residence country because not considered to have been triggered there under that country's nonrecognition principles.

Numerous other examples of such circumstances could be cited. For good reason, tax treaties generally have not been designed to test for actual double taxation on an income-item-by-income-item or transaction-by-transaction basis. Instead, they assume that a sufficient risk of double taxation exists when income is paid from one country to a tax resident of the other country that a source country tax reduction is justified. They do not then inquire into the manner in which the residence country chooses to exercise its taxing jurisdiction over that income in every particular case.

Indeed, the OECD, in considering appropriate treaty formulations of anti-abuse rules, specifically rejected a "subject to tax" approach that would have required a risk of actual current double taxation on any item of income before a treaty benefit could apply.[11] Thus, the policy that treaties are not designed to create opportunities for double exemption must be balanced against the policy that source country treaty benefits to a resident of another country are not designed to be conditioned on an item-by-item or transaction-by-transaction finding of the possibility of actual double taxation.

Of course, when treaty partners view certain kinds of double exemption possibilities as reaching unacceptable levels, such as may be the case for the types of hybrid mismatch arrangements described in the Action Plan, they can and often do deal with that quite legitimately by including targeted anti-abuse provisions in their treaties. The IAPT simply wishes to stress that not all double exemption (or exemption plus deferral) scenarios which arise from different treatment of an item or entity under the two countries' laws warrant a denial of treaty benefits, so it is important to draft such anti-abuse provisions carefully.

The IAPT also notes that a variety of different provisions have appeared in treaty practice over the past decade or more, aimed at avoiding double non-taxation in hybrid mismatch arrangements. For example, the United States alone has used at least six different formulations of its provision relating to fiscally transparent entities in its treaty practice in the past 10 years.[12] The experience of the business community is that such formulations, including the one based on the 2006 U.S. Model Treaty which is used most frequently, all pose issues of interpretation for which clear guidance would be desirable. These types of

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[11] OECD, "Double Taxation Conventions and the Use of Conduit Companies", (1986).

[12] See, e.g., the U.S. treaties or protocols with Poland (2013), Belgium (2006), Sweden (2005), France (2009), Canada (2007), and Japan (2003).

provisions tend to present significant drafting challenges, due in part to the variety of situations they are intended to address. The IAPT therefore encourages the OECD, if it intends to introduce new provisions into the OECD Model to address hybrid mismatch situations, to issue such proposed changes in discussion draft form and to provide an adequate opportunity for comment so that such issues of interpretation can be adequately addressed.

It is certainly the case that the majority of double non-taxation situations attributable to hybrid mismatch arrangements arise from the interplay of countries' purely domestic law and do not depend upon treaties for their existence. It therefore makes sense to consider domestic law solutions to those hybrid mismatches. The IAPT notes that the 2012 report on hybrid mismatches concludes that specific and targeted "linking" legislation, which ties the availability of benefits in one country to the non-use of benefits in another country, holds significant potential to address hybrid mismatches and has produced positive experience for the countries that have tried it.[13]

While the IAPT does not dispute that such linking legislation has the potential to significantly reduce double non-taxation situations attributable to hybrid mismatches, it does wish to sound a note of caution about the need to design such legislation carefully in order to avoid the possibility that attempts to stamp out instances of double non-taxation lead systematically to double taxation. The example of the U.S. and U.K. rules on the cross-border use of losses may help to illustrate this point. The U.S. rules on so-called "dual consolidated losses" deny the ability to use a loss incurred by a dual resident company (or a separate unit of a domestic company) to offset the income of a domestic affiliate where that same loss can also be used to offset the income of a foreign company for foreign tax purposes. The United Kingdom has somewhat similar rules, including rules developed after the 2005 ECJ decision in the *Marks & Spencer plc v. Halsey* case (C-446/03), when the ECJ ruled the United Kingdom had to allow group loss relief on losses arising from EU subsidiaries when there were no possibilities of using the loss in the subsidiary State.

Both sets of rules have led to substantial interpretive disputes about how to determine whether a foreign tax benefit could or would be obtained with respect to the loss in question. The U.S. rules have undergone a series of amendments in order to reduce the complexity and initially overly punitive application of that test.[14] The U.K. rules have been the subject of litigation in both the United Kingdom and the ECJ on whether they were drawn too restrictively so as to systematically preclude tax relief anywhere for real commercial losses.[15] The issues relate to questions such as when the determination is

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[13] That report references, for example, the U.S. dual consolidated loss rules of Section 1503(d) of the Internal Revenue Code and the U.K. group relief loss limitation rule of Sections 106 and 107 of the Corporation Tax Act 2010..

[14] See, e.g., Greenwald and Fuselier, "The Remarkable Taxpayer-Friendly Evolution of the DCL Regime", 54 Tax Notes Int'l 161 (Apr. 13, 2009), 2009 WTD 73-11, for a description of the changes made.

[15] See, e.g., HM Revenue & Customs v. Marks & Spencer plc; [2013] UKSC 30 (May 22, 2013); Commission v. United Kingdom, C-172/13 (action brought in ECJ on April 5, 2013).

made of whether a foreign benefit is or will be possible, what facts are considered or assumed for purposes of making that determination, what procedural hurdles the taxpayer needs to clear to obtain the domestic benefit, what the effect is of foreign legislation which basically mirrors the domestic rule, etc. In short, the experience of business has been that such linking legislation can be extraordinarily complex to apply in practice, and that it must be pragmatically and thoughtfully designed in order to avoid a systematic shift to double taxation. Here, too, the IAPT respectfully suggests that the OECD could benefit from consultation with business if it wishes to avoid some of the pitfalls that have characterized early efforts at designing linking legislation.

One point worth noting with respect to hybrid mismatch effects under both treaties and domestic law is that many hybrid mismatches produce effects which amount to timing mismatches only. In such cases, a permanent denial of benefits in one country on the grounds that there is no current detriment in the other country could result in effective double taxation when the mismatch reverses itself in that other country. There is obviously a policy decision to be made as to whether anti-hybrid rules should be designed to apply to such timing mismatch hybrid situations, or whether that is disproportionate to the problem. Even if policymakers believe anti-hybrid rules should apply in such cases, an appropriate approach could be to have those rules defer the benefits in the first country until the hybrid effect is reversed in the second country, rather than denying benefits in the first country altogether. The IAPT notes, however, that taxpayers can face complex tracking challenges if they are forced to demonstrate the timing of a later year detriment in the second country in order to claim the original benefit in the first country. We therefore urge the OECD to weigh carefully the justification for applying anti-hybrid rules to timing mismatch situations against the risk of double taxation that could create.

The IAPT further notes that the potential complexity of anti-hybrid rules can be mitigated from the taxpayer's perspective if the relevant regime includes both thorough public guidance on the tax administration's approach to applying the anti-hybrid regime and a clearance mechanism to provide certainty in individual cases. Also, rules which are not drafted to cause an automatic denial of benefits, but which give the taxpayer an opportunity to defend its claim to benefits, provide welcome flexibility to what could otherwise be an overly rigid regime. The IAPT notes that these kinds of features can be found in the U.K.'s anti-arbitrage regime.

Action item #2 refers to the possibility that guidance on coordination or tie-breaker rules may be developed to address cases where more than one country seeks to apply such rules to a transaction or structure. If implementation of the basic recommendations to be developed under action item #2 leads to a proliferation of domestic linking legislation in countries across the world, the need for such a workable tie-breaker solution to avoid double denials of benefits (and hence double taxation) should not be underestimated. The IAPT notes that there is already precedent in both domestic rules and international

practice for allowing the taxpayer to elect the jurisdiction where the benefit is to be claimed,[16] and it encourages the OECD to develop guidance that follows that general pragmatic approach.

Finally we note that challenges could arise from requirements to disclose all hybrid arrangements, including the potential difficulty of identifying the relevant hybrids in the first place. Here again, experience has shown that while many hybrid arrangements result from conscious planning on the part of taxpayers, others arise more naturally as a result of the ever-present differences between national tax systems, and taxpayers should not be penalized if they do not always immediately recognize the existence of a hybrid possibility. Moreover, experience has also shown that there can often be good faith disagreements about whether a particular situation fits within the relevant hybrid arrangement definition, which also highlights the need for reasonable rules surrounding any reporting requirements.

[16] See, e.g., the so-called "domestic use election" under the U.S. dual consolidated loss rules in Treas. Reg. section 1.1503-2(g)(2); U.S.-U.K. competent authority agreement of October 6, 2006.

30 April 2014

the global voice of the legal profession

Public Discussion Draft: BEPS Action 2

Neutralise the effects of hybrid mismatch arrangements

Comments of the Tax Committee of the International Bar Association

We have a number of concerns of a fundamental nature relating to the current proposals in relation to hybrid entities and hybrid instruments. We have not therefore sought to address the specific questions raised in the Discussion Draft, although we do believe that the proposals are broadly sensible if one accepts that tackling hybrids by means of seeking uniform legislative change around the world is a proper exercise for the BEPS project to include. However, this is not our view.

The issues raised by hybrid instruments and entities are of a different character from the great majority of the other BEPS issues being addressed by the OECD. This is because they can currently be addressed by the unilateral action of states, as indeed is recognised by the Discussion Draft which recommends tackling the issue primarily through the implementation of domestic law. No treaty change is required; no deviation from an accepted international norm need occur. Furthermore the opportunities offered to taxpayers by the use of hybrids have not arisen as a result of technology-driven changes in the way in which business is carried on, unlike the majority of the issues within the BEPS agenda. They pre-date the coming of digital commerce by some distance. They are merely a consequence of the inevitable differences between tax regimes.

It is therefore our view that no OECD intervention is necessary or appropriate in the area. Individual states may if they wish introduce their own legislation in this area now, without the agreement of trading partners. Indeed some states have done this, and of course others considering such measures can if they wish study the operation of anti-hybrid rules in those states which have introduced them. Alternatively – and historically this has been much more the norm - states may introduce legislation which does not target hybrid arrangements specifically, but (for instance) limits the ability of residents to claim deductions in circumstances of particular concern, or limits the availability of exemptions in similar circumstances.

It is in our view unrealistic to expect all (indeed, possibly any) states to introduce such rules in response to a request from the OECD. Similarly it is unrealistic to expect that even if some states do decide to introduce anti-hybrid rules in response to the BEPS initiative, they will all do so in accordance with any model produced by the OECD (if indeed a single model legislative code is capable of being produced which would operate equally effectively in the context of all the world's very different tax regimes). To illustrate the point, states do not as a rule adopt

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the OECD model tax treaty wholesale – they use it as a basis for negotiations, but frequently end up with treaties that look very different from the model in important respects. Implementation of anti-hybrid rules – if it happens at all - must be expected to follow the same pattern.

We have a very significant concern that if anti-hybrid legislation is not implemented on a uniform basis, double taxation or other iniquitous results may ensue. In particular, we do not believe that states will follow the Discussion Draft's approach of not seeking to identify which state has lost revenue where a hybrid is involved: if a state is minded to legislate on the issue it will do so because it believes that it is losing revenue. It will therefore be unlikely to follow the Discussion Draft's "waterfall" approach, and instead pass measures designed to restore the revenue which it considers itself to have lost.

We are also not persuaded as to why it is necessary to seek a new uniform approach to counteracting the effect of hybrids where actual payments are made, but not where they are not. Economically we see no difference between the tax result where a regime allows notional deductions on equity (which do not give rise to corresponding receipts elsewhere as they are only notional) and where a combination of regimes allows a payment to be deductible in one jurisdiction but not taxed on receipt. The fact of the payment is irrelevant to the tax mismatch.

Similarly we do not see the conceptual difference between the tax effects of hybrids and simple rate arbitrages. For example, in a classic hybrid structure a state which would not generally be regarded as a low-tax jurisdiction has chosen to exempt a certain category of receipt from tax so enabling a deduction to be achieved in another state without a corresponding charge. How is this different from allowing a deduction for a payment from a high-tax state to a zero-tax state? Or even from allowing a deduction for a payment from a higher tax state to a lower tax state? In many cases the differences between mainstream tax rates in developed economies are greater than the differences between the some of the lower of those tax rates and zero.

Perhaps the clearest example of the problem would be to imagine a state which is content to exempt payments of a nature which are deductible when made by entities resident in a major trading partner with a corporation tax rate of 25%. As drawn, the proposals in the Discussion Draft would apply to such an arrangement. However, suppose that the recipient state imposes a tax rate on the payments of 0.25%. The payment is no longer exempt from tax in the recipient state, and the suggested anti-hybrid rules would no longer apply, although the arbitrage benefit is retained almost in full. Should the rules therefore specify a minimum rate of tax to which the receipt must be taxed before a deduction can be allowed? If so should that rate be absolute, or relative to the tax rate in the state where the payer is resident? Such provisions are a feature of typical CFC regimes which require the CFC to be subject to a defined lower level of taxation before they operate to impose a charge.

In our view the proper role of the BEPS project is to advance the development of norms in the principles of international taxation such that states which wish to tax profits can do so fairly and within those norms. Perhaps the most obvious area where change is needed is profit attribution (whether achieved via calculating the contribution of a permanent establishment to the overall profits of an enterprise, or via the operation of transfer pricing rules between related companies). This is an area where few states seek to determine their own detailed rules and enshrine them in law, and many choose to adopt the OECD's guidance (whether as a practical matter or, as for example in the UK, explicitly via legislation).

Addressing the issue of hybrids is very different. In the hybrid case, states are entirely at liberty to legislate as they choose already, so if they have not that must be assumed to be a deliberate choice. There is no international norm – whether expressly derived from tax treaties, or impliedly derived from behaviour – which would restrict a state's options. Where hybrid structures deliver tax advantages it is normally the case that each of the tax systems involved is working exactly as its designers would have intended. Attempting to instruct states to change this is akin to instructing states to change their tax rates, which the OECD quite properly recognises is outside its ambit. Perhaps more than in any other area of the BEPS project, when looking at hybrids we are looking at an area where base erosion has occurred as a positive policy choice of the states whose base is being eroded. It is unrealistic to expect states that have chosen that path to reverse their direction. It is not in our view a proper object of the BEPS project to seek to instruct states to tax profits which they have chosen not to tax.

One might consider an analogy with permanent establishments. The BEPS project may well result in adjustments to the current widely accepted definition of a permanent establishment. If this is the outcome, and it feeds through into the interpretation of tax treaties, the result will be that states are entitled to tax businesses based elsewhere in different circumstances to what is now the case without contravening an international norm. Those states would not however be obliged to levy tax in such cases – the decision to tax must remain one for the sovereign state. In the hybrid sphere states are already fully entitled to tax receipts or deny deductions if they wish within current international norms, but many are quite legitimately choosing not to do so.

Furthermore, an unintended consequence of the hybrid proposals may be to boost the economies of low-tax jurisdictions at the expense of others. In a great number of cases where a state chooses to exempt a category of receipt from tax, the decision will have been driven by a desire to attract or retain the business of collecting receipts of that type within its borders rather than see that business move to a low-tax jurisdiction. Any rules which prevent the tax benefits of unmatched deductions arising between developed jurisdictions with generally conventional tax rates but which do not attack the equivalent benefits when payments are

made to low-tax jurisdictions can only operate to the advantage of the low-tax jurisdictions. As a wider policy matter this cannot be an outcome which the OECD should promote.

Finally we would note the difficulties of imposing anti-hybrid rules which apply automatically and uniformly within the European Union. The Cadbury Schweppes case has already held that CFC rules contravene the Fundamental Freedoms set out in the Treaty of Rome unless there is an artificial diversion of profits involved – we would expect any anti-hybrid rules to be subject to similar constraints. An EU state is almost certainly not at liberty to pass legislation which will (for example) allow a deduction in respect of a particular category of payment if that payment is made to a fellow resident of the state in question, but which does not allow the same deduction on a payment to a resident of another Member State if there is genuine substance in that other Member State such that the making of the payment does not amount to an artificial diversion of profit. Indeed if the restriction on deductibility is found to be an infringement of the free movement of capital, as in many structures may well be the case, then its imposition would potentially be unlawful even in relation to payments between entities within and without the EU.

We therefore have grave reservations as to whether hybrid arrangements should properly fall within the BEPS project at all. We do not see that hybrid arrangements are conceptually different from other cross-border rate arbitrages, and so in our view it is wrong to seek to attack hybrids without addressing those other arbitrages. Given that in our view it is clear that it is not the proper role of the BEPS project to seek harmonisation of tax rates, we do not see that those other arbitrages can be addressed as part of the project and accordingly we do not believe that hybrids should be either.

More widely, to reiterate, we believe that the role of the BEPS project should be to give states the tools they require to limit base erosion if it is their policy to do that. Where states choose instead to engage in tax competition and consciously permit erosion of their tax bases, that is an exercise in sovereignty which must be left to them. We do not consider that the proposals on hybrids do give states any new tools: the necessary tools are already fully available to those who wish to use them. The BEPS project will not, and should not be expected to, alter national policy in this respect.

# *Comments to the OECD Discussion Draft on Action 2 "Neutralise the Effects of Hybrid Mismatch Arrangements"*

The International Chamber of Commerce (ICC) welcomes the opportunity to provide comments on the Discussion Draft regarding BEPS Action 2 to neutralise the effects of hybrid mismatch arrangements. ICC acknowledges that certain hybrid mismatches relating to instruments and entities can cause BEPS related concerns, and ICC supports the OECD in promoting coordinated action to address those concerns whist at the same time ensuring that cross-border trade and investment is not discouraged.

ICC has identified below a number of high-level concerns in relation to the Discussion Draft:

- ***Interaction with other Action Items:*** As the BEPS project continues, it becomes clearer that there is significant interaction across many of the 15 Actions. ICC believes that further work is required to understand those interactions, and how the full spectrum of BEPS proposals may address government concerns when considered together. This is particularly important for all of the September 2014 Actions, to ensure that proposals that might be adopted by various governments in the near-term do not result in negative consequences when future BEPS proposals are developed.

  In relation to Action 2, there is a risk that acting on hybrid mismatches without acting in coordination with other BEPS Actions would result in an unlevelled playing field. We encourage the OECD to articulate the policy rationale for distinguishing between hybrid arrangements and other types of mismatches, as this would help inform decisions about the adoption and shape of the proposed rules.

  In addition, hybrid mismatches are a symptom, rather than a cause of BEPS. The OECD's work on BEPS Action 4 and the development of more uniform expense deduction rules may deal more effectively with the cause, without such a significant need for the complex domestic law solutions proposed in the Discussion Draft. As ICC acknowledges that the timetable cannot be changed, the emphasis should be on establishing a framework for all BEPS Actions to be reviewed and considered in 2015 to ensure that further action undertaken is coordinated and coherent.

- ***Complexity of the Rules:*** The Discussion Draft does not acknowledge the significant complexity that the proposals will create. The tax treatment of particular transactions across borders can be difficult to determine, even in a related party context due to various factors (including timing issues and differences in accounting concepts). For unrelated party transactions, the complexity increases further. The proposal needs to address the complexity of implementing and managing these rules from the taxpayer and tax authority perspective. Defining what is considered abusive (through a "bottom up" approach) could assist here to avoid targeting commercial arrangements, rather than including all hybrid arrangements (through a "top-down" approach).

- ***Impact on certain Market Segments:*** The Discussion Draft does not fully consider the effects of the proposed rules on very important segments of the economy. For example, ICC is concerned about the FS funds and banking sectors, and fears that methods used to raise capital would be significantly impacted by the proposals. ICC does not believe that there has been time to fully investigate these issues before conclusions will be reached. There will be many other similar issues across other sectors of the global economy; for example, non-FS corporates with in-house treasury functions (including cash pooling arrangements) would also be impacted.

- ***Allocation of Taxing Rights:*** ICC is concerned about the impact of the proposals on the allocation of taxing rights between states. For example, as part of the proposals to address Imported Mismatches, the rules propose that a third country (that is not actually party to a hybrid transaction) can apply rules as a 'back-stop' to deny a deduction where two other countries may have chosen not to execute their rights.

  Without an enquiry into the policy rationale of the two countries that have not sought to tax (or deny a deduction for) the payment, or enquiring into the tax effects of that non-hybrid payment (e.g., as to timing, partial relief, etc.) this appears to be a "soak-up" tax. If the payment in question is objectionable, ICC believes that there should be a more general consideration of whether it should be dealt with under BEPS Action 4 to ensure equal treatment of hybrid and non-hybrid payments. Again, if a "bottom-up" approach is adopted, this would be clearer.

- ***Use of hybrids to avoid double taxation:*** ICC notes that in some cases, taxpayers use hybrid entities and instruments to achieve self-help relief from double taxation (for example, resulting from non-creditable withholding taxes, application of loss expiration rules and inconsistent application of the PE concept and the arm's length principle). As the Discussion Draft stands, ICC is concerned that the proposed rules would make this form of relief impossible. The OECD's work on dispute resolution is a critical component of providing the certainty that business needs by addressing the double taxation issues that MNCs currently face and that a number of new international tax rules will create (including the proposals on hybrid mismatches and tax treaty abuse).

ICC believes that the Discussion Draft focuses too heavily on eliminating tax arbitrage without allowing the time to fully understand the potential unintended consequences of the proposals. Although ICC understands the political imperative behind this project, and the need to move quickly, ICC believes that not every issue needs to be resolved immediately. Decisions that could have potentially negative and unintended consequences for the wider economy should be well considered. Arbitrage is an important part of the issue, but equally important is the creation of a proportionate and workable approach that provides the stability and certainty that businesses need to invest.

The International Securities Lending Association
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***Emailed to*Error! Hyperlink reference not valid.*: aggressivetaxplanning@oecd.org**

2nd May 2014

**BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (recommendations for domestic laws)**

On behalf of our members, the International Securities Lending Association (ISLA) appreciates the opportunity to provide its initial comments on the OECD Public Discussion Draft (referred to below as the hybrid mismatch paper).

ISLA is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. It has approximately 100 full and associate members principally from across Europe comprising banks, securities dealers, asset managers, insurance companies and pension funds. For more information please visit the ISLA website www.isla.co.uk.

We write in connection with one specific aspect of the hybrid mismatch paper, namely in reference to the discussion in that document concerning stock lending and repo transactions.

We recognise that, in the terms of the document, a stock lending or repo transaction could give rise to a hybrid effect. This possibility arises due to the fact that some tax authorities may choose to treat payments under a stock lending or repo arrangement (e.g dividend compensation payments) as a deductible expense (or taxable receipt) whilst others may seek to assimilate them to the income (typically dividends in a stock loan transaction) forgone by the lender by lending out those securities over a dividend record date and such income may in some cases fall to be treated as an exempt receipt (or non-deductible payment) by virtue of the relevant domestic tax system concerned.

In the light of this situation, we are concerned at the risk that this theoretical possibility, if it leads to a wide application of the proposed and highly complex hybrid regime to stock lending and repo transactions, will lead to major adverse impacts on ordinary over the counter (off-Exchange) stock lending and repo transactions which play a vital role in facilitating market liquidity.

In the event any anti-hybrid rule were enacted to apply broadly to stock loan and repo transactions, it would require parties to such transactions to have access to continuous and up-to-date knowledge of the tax systems of the numerous markets in which securities are borrowed and lent. Further, given the prevalence in this market of chains of various counterparties acting in either an agency or a principal capacity, then the potential for administrative complexity would be enormous and unmanageable.

These issues - and our concerns - are not limited to transactions between unrelated parties. The structure of the financial markets and the purpose of stock lending and repo transactions (being to access and utilise available pools of stock and liquidity for daily flow business) inevitably mean that there are also significant levels of related party (such as intercompany) stock borrow and loan transactions.

The transactions described above, whether involving unrelated or related parties, have overwhelmingly no tax driver and we are concerned that if brought into the hybrid regime the costs and adverse impact on the global financial markets would be appreciably out of all proportion to any anti-tax avoidance benefits secured.

We would also add that the examples of stock loan and repo transactions given in the hybrid mismatch paper do not by any means reflect ordinary market transactions but seem rather to be highly structured transactions geared to deliver tax, not liquidity, benefits. Accordingly, they would by no means be representative of the market transactions discussed in this letter.

For the reasons set out above, we would suggest that a complete carve-out from the hybrid regime is required for ordinary market stock loan and repo transactions, including those between related parties. This might mean that the use of a structured purpose or motive test needs to be considered. This would inevitably increase the level of uncertainty (and therefore still negatively effect) ordinary stock loan and repo transactions, but it may be possible to devise safe harbour parameters which would reduce the unwarranted impact of any tax anti-avoidance rules on such transactions. If it would be helpful, we would be pleased to develop our thoughts in this regard, although our strong preference is for a clear carve-out as indicated above.

Yours sincerely,

John Billige
Chair ISLA sub-group tax

INTERNATIONAL UNDERWRITING ASSOCIATION OF LONDON

2nd May 2014

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

**For e-mail transmission to: aggressivetaxplanning@oecd.org**

Dear Mr Pross,

Thank you for inviting comments on the OECD Public Discussion Draft concerning BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for domestic laws). We appreciate the opportunity to provide input and will focus on the questions which are of particular relevance to our members and to the insurance industry in general.

The International Underwriting Association of London (IUA) represents international and wholesale insurance and reinsurance companies operating in or through London. Its purpose is to promote and enhance the business environment for its members. We estimate that premium income for the London company market in 2012 was £24.225bn.

THE WORLD OF INSURANCE

The executive summary sets out the key points of our detailed responses.

**Executive summary**

There are three key points we wish to make.

- BEPS is aimed at reducing the opportunities available to multinational businesses that may not available for domestic businesses. It is not aimed at normal commercial transactions between third parties. The proposals contained in this paper attempt to expand the scope far beyond intra-group transactions, which is not realistic or workable.

- Regulatory debt should be excluded from the proposed changes so as to ensure that financial services groups are not disadvantaged. Regulatory debt is as important for insurance groups as it is for banking groups and the concerns expressed by the banking industry over its ability to raise capital efficiently because of regulatory constraints must be extended to the Insurance industry on an equal basis within the BEPS Action 2 paper. We are pleased to note that the paper considers a possible exemption for regulatory capital and we take the opportunity in our responses below to provide support for that, which we see as the key to reaching a workable solution for the financial services industry.

- The proposals should be introduced only if **all** OECD countries agree to implement them unilaterally in their domestic legislation.

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**Detailed comments**

We comment below on the proposals in the same order as is followed in the Discussion Draft.

**BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)**

**II. Design of Hybrid Mismatch Rules (questions page 14 under para 47)**

1. **Are the objectives and design principles of the hybrid mismatch arrangements clear?**

2. **If further clarification is required, then where is this required and how could it best be provided?**

It is understood that there may be concern over certain intragroup financing arrangements where there may be some instances of one group company being able to impose terms that may not have been available between third parties. However, it is not at all clear why transactions between third parties should be scoped in to the proposed changes. What is the mischief anticipated? It should be possible to achieve the desired outcome without including transactions between third parties and also without including normal commercial transactions between group companies.

We are concerned to note that there is no motive test being offered in the design principles (para 4). While that appears to be seen as a way of keeping the application of the rules simple (i.e. not requiring a jurisdiction to prove it has lost revenue), it has the potential greatly to increase the scope and volume of transactions brought within the rules, many of which will not be the target of the proposals, as rather than having to prove that there was no 'abuse' involved in a transaction, an entity or group may now need to map each and every hybrid transaction through its lifetime.

In comparison, the tax arbitrage rules in the UK are based on the existence of a tax avoidance motive coupled with the broad requirement for there to be a hybrid entity or hybrid instrument. These requirements are relatively simple to apply in practice and therefore it is generally clear when the rules are applicable and when they are not. We would refer the Working Party to those rules as a way of providing clarity to taxpayers.

It is interesting to note, however, that at para 121 b), the consideration of whether or not something has been 'designed to produce a mismatch' would imply a motive – which was specifically rejected in the preamble to the document (as noted above).

There should be a requirement for all OECD members to adopt the final proposals unilaterally in order to provide consistency and fairness. We are concerned that a lack of timely adoption or inconsistent adoption in domestic laws will give rise to an unworkable and untenable position for taxpayers as they seek to apply the rules.

## IV. Hybrid Financial Instruments and Transfers (page 43 under para 162)

### 1. Is it clear what elements need to be present in order for the rules neutralising hybrid financial instruments or hybrid transfers to apply?

The hybrid financial instrument rule is not clear about whether it is the payee or the payer who has the primary responsibility for deciding whether or not the rule should be applied in the other territory.

Page 25, Recommendations – a) suggests that, if the payee does not include the payment as ordinary income, then a deduction should be denied for the payer. In other words, the treatment for the payer is determined by the application of the rule by the payee. However, that is contradicted at para 108 b), where the payer is required to apply the 'primary rule' of deductibility or otherwise of the payment and once that is established, then the payee determines whether or to what extent the income should be recognised as ordinary income.

It should not be possible for the primary and the secondary/defensive rule to apply to the same instrument – and it is not clear how the linking rule will work in practice.

Para 84 – it would be difficult and unhelpful for wider company law purposes for domestic law definitions of 'dividend' to be altered. It would be more appropriate, as also suggested, for jurisdictions with dividend exemption rules to modify the eligibility of those exemptions, for this purpose.

Further modifications to the definition of 'dividend' would therefore be unwelcome and could create considerable uncertainty from a commercial, legal and tax perspective for businesses generally.

The UK rules may be a useful reference point, as they deny an exemption for dividends which are tax-deductible under the law of the payer's territory or where, more widely, the dividend is paid as part of a tax advantage scheme – and a deduction is allowed to a resident of any territory outside the UK under the law of that territory in respect of an amount determined by reference to the distribution.

### 2. Is the outcome of the rules' operation clear?

The intention of the outcome is clear to the extent that it is designed to capture and neutralise DD or D/NI transactions. However, there is great concern over the compliance burden that could potentially arise, in particular in relation to the top-down approach.

Para 88 suggests that timing differences will not in themselves bring into scope a financial instrument that would not otherwise be caught. However, it is not clear whether the treatment for both payer and payee should be determined at the beginning or the end of the life of the instrument, what would happen in the event that the rules in one or other jurisdiction changed during the life of the instrument and whether or not any grandfathering provisions are being considered.

**3. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?**

We are not aware of any such arrangements, but would like to stress that, if there are other areas highlighted by other bodies during this consultation process, then there would be a concern that any future changes should not have an impact on any genuine transactions and the arrangements should not be looked at in isolation or without due consideration of the impact on the insurance industry.

**4. This document sets out two possible approaches to drafting a scoping rule and summarises the possible advantages and disadvantages. Are the advantages and disadvantages accurately described and are there any other advantages and disadvantages of the two approaches?**

It is encouraging that issuers of regulatory hybrid capital instruments have been considered specifically and the challenges they face acknowledged. Insurance groups face similar restraints on their ability to raise regulatory capital efficiently.

**a. What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration?**

The top-down approach, as outlined, will have the effect of capturing an excessive amount of information, which would be beyond what would be required for this purpose.

The bottom-up approach may give a more measured approach to achieving the same objective.

However, in our view, groups should be able to choose either top-down or bottom-up. Provided a consistent approach is applied, it should be possible to provide the necessary information in a way that fits best with the accounting systems and the reporting GAAP of each taxpayer group, rather than trying to impose a single approach on all. We would refer the Working Party to the comments we submitted on the country-by-country reporting consultation, which takes the same approach.

**5. This part includes a number of examples:-**

**a. What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties position?**

In most instances there will be no obligation on a taxpayer to provide what could be sensitive information to an unconnected party and therefore the provision of such information by one party to another may be in breach of local regulation. Any requirement to do so would therefore need to be specifically built into the terms and conditions for entering into a transaction or issuing a particular type of instrument. It is difficult to see how that would be workable in practice.

We strongly rebut the proposal to treat a 10% investor as a ‘related party’. It is completely unrealistic and unworkable and must be revised.

We suggest that a connected party should be defined instead using the concept of the 'consolidated group' under international GAAP. That would provide clarity and consistency across jurisdictions and would also exclude third party transactions, which, as noted above, should not be within the scope.

**b. In this context are there any examples or situations that are more problematic than others? If so please explain why problems arise and what constraints or restrictions the parties might face in obtaining relevant information on the treatment of the counterparty?**

No comment

**c. To the extent there are difficulties; do these apply equally to both the holder and issuer in the context of hybrid financial instruments?**

No comment

**d. Are there any other situations or examples, not covered here, that give rise to difficulties? In particular are there any specific problems for regulated businesses (see also Q. 8 below)?**

No comment

**6. What definition could be used to capture the concept of widely-held or regularly traded whilst also addressing concerns that any exemption should not be available to related parties, parties acting in concert or parties to a structured arrangement (i.e. an arrangement designed to obtain the benefit of a mismatch).**

No comment.

**7. If the rule exempted certain traded instruments then how could it be drafted so that it still applied to structured arrangements?**

It would be difficult to draft a suitable definition that would be broad enough to capture the targeted transactions, but without bringing into the scope the much larger number of non-abusive or non tax-advantaged transactions.

We reiterate our strong recommendation that third party transactions be taken out of the scope and that a motive test be included (such that normal commercial transactions would be outside the scope). If both of those were implemented, then the desired objective should be achieved without the need for a definition.

**8. In relation to regulatory capital:**

**a. What are the regulatory requirements for banks' to issue/manage capital at top holding company level, and what arrangements are used to pass this down the group? For example, what use is made of identical and traceable instruments and under what**

**conditions would the arrangement be funded by a market issuance at top holding company level?**

**b. Are special provisions needed to create parity between a banking group issuing hybrid regulatory capital indirectly to the market through its holding companies and a banking group (or other industry group) issuing hybrid regulatory capital directly to the market?**

**c. Are hybrid regulatory capital instruments sufficiently different as to justify a full carve-out from hybrid mismatch rules? Are there inherent safeguards in place against the use of these instruments for tax-planning purposes or what safeguards could be introduced to ensure that any exemption from the general hybrid mismatch rules could not be abused?**

Insurance groups are required to meet capital adequacy requirements by insurance industry regulators and so are subject to similar constraints to the banking industry. Debt instruments which are able to be included for capital/solvency purposes will have certain features relating to interest deferral and loss absorbency which make them similar to equity. Those features are currently mandated by local regulators and could potentially be more stringent once Solvency II is introduced in 2016.

These debt instruments have not been designed with tax mismatch in mind, but instead are required to ensure that the insurance industry is able to meet its capital adequacy requirements effectively and efficiently. If an insurance group were unable to take an interest deduction on these hybrid instruments, then the cost of supporting its capital adequacy would be greatly increased and would be damaging not only to the industry, but also to the purchasers of insurance products.

Insurers are required to obtain credit ratings (typically from Moody's or Standard & Poor's), which are designed to inform an external party about the creditworthiness and capability of that insurer's business. If a group were required to replace its hybrid capital instruments with more expensive equity or became highly leveraged, that is likely to have a negative impact on its credit rating, which could then have an impact on its commercial attractiveness. Decisions on how to fund an insurance group will also be affected by the cost of the various types of capital. As a general rule, equity capital is one of the most expensive forms of capital and the insurance industry would be disadvantaged if, as a result of these proposals, it were forced to meet its regulatory requirements with equity capital.

Over the last 10 years, insurers in EU countries in particular have been required to hold greater levels of capital in order to strengthen their ability to withstand market shocks or unexpected losses. The holding of regulatory hybrid capital has been encouraged as a means of providing a cost-effective way to achieve that and to raise non-dilutive capital. If the ability to deduct interest on them is denied, then there is an enormous concern that EU insurers will be at a competitive disadvantage with non-EU insurers and also that the costs to the ultimate consumers will be greatly increased.

For insurance groups, it is quite common for hybrid regulatory capital instruments to be issued externally at Topco level and then passed down the group. However, that is not always the case. The decision on where to issue them will depend on a number of commercial considerations, for example the recognition of regulatory capital by different local regulators, the need to have access

to a particular capital market to benefit from certain terms and conditions being offered at a certain point in time and the extent to which there is cash already available in Topco or elsewhere in the group.

Some groups may have a dedicated Group Treasury company which would be used to obtain better market rates than one of the regulated intermediate holding companies. The UK's new CFC regime was introduced only 16 months ago and a number of groups have been restructuring their group treasury functions and other operations to comply with the new regime. It would be disruptive if further restructuring were required to deal with additional and overly burdensome legislation on hybrids.

Hybrid regulatory capital instruments will typically be passed down a group on a like for like basis – but not always. Again, the facts and circumstances of the group will ultimately determine the flow of funds.

For the numerous reasons mentioned above, it is clear that special rules are required to create parity between an insurance group issuing hybrid regulatory capital indirectly to the market through its holding companies and an insurance group (or other industry group) issuing hybrid regulatory capital directly to the market. Again, we suggest that the incorporation of a motive test would exclude from the proposals instances of intra-group debt which have been put in place to support these regulatory requirements.

Hybrid regulatory capital instruments may have a similar or the same form as other instruments. However, it is the purpose for which they are being held (to support regulatory capital requirements) that should be sufficient to allow them to be excluded from the scope. If similar instruments are held which are in excess of what is required for regulatory purposes, then the excess funding could be considered within the scope.

**V. Hybrid Entity Payments (questions page 55 under para 196)**

1. **Is it clear what elements need to be present in order for the rules neutralising deductible hybrid entity payments to apply?**

Yes.

2. **Is the outcome of the rules' operation clear?**

The desired outcome is clear, but we remain concerned about how the rule can be operated in practice.

3. **Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?**

We are not aware of any such arrangements, but would like to stress that, if there are other areas highlighted by other bodies during this consultation process, then there would be a concern that any future changes should not have an impact on any genuine transactions and the arrangements should not be looked at in isolation or without due consideration of the impact on the insurance industry.

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4. **Are there any related party structures where the hybrid entity may have difficulty in knowing or obtaining information about the position of the investor?**

**and**

5. **If so when would these arise and what difficulties or constraints would the hybrid entity face?**

Provided the definition of a 'related party' is based on that of a consolidated group under GAAP, then it would be reasonable to expect that relevant information could be obtained.

However, where a related party is deemed to include a much wider pool of lower level investors (e.g. towards the 10% level of ownership), then we anticipate a large number of practical and legal difficulties in obtaining the details required. That is because specific corporate involvement is diminished and related involvement and understanding are correspondingly reduced. In this scenario, delays in understanding the position could be expected and it may not be until a few years later following a tax audit or agreement with the relevant tax authorities that the position is fully understood.

**VI. Imported Mismatches and Reverse Hybrids (questions page 66 under para 236)**

1. **Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?**

We are not aware of any such arrangements, but would like to stress that, if there are other areas highlighted by other bodies during this consultation process, then there would be a concern that any future changes should not have an impact on any genuine transactions and the arrangements should not be looked at in isolation or without due consideration of the impact on the insurance industry.

2. **Is it clear what elements need to be present in order for the defensive rule neutralising reverse hybrids and imported mismatches to apply?**

A defensive rule in the payer's jurisdiction is not favoured as a method of neutralising reverse hybrids and imported mismatches, as it introduces yet a further layer of complexity to the proposals.

Alternatively, an appropriate focus/use of the anti-avoidance rules in the jurisdiction of the recipient country could be a better approach. Thus, if it is decided that a defensive rule is required, that should come into play only where methods for neutralising the mismatch have already been exhausted in the recipient's territory. There should be an override of the defensive rule where the main purpose is not tax avoidance.

It will also be important to ensure that there is a suitable exclusion from the defensive rule for commercial arrangements involving hybrids entered into by banking and insurance groups (please see question 8 in relation to IV above). The concept of "offset by expenditure incurred under a

hybrid mismatch arrangement" needs to be clarified and, in particular, it should not apply to the normal use of tax reliefs in a jurisdiction against taxable receipts such as the offset of local tax losses and the use of tax grouping rules.

**3. How could an anti-abuse provision be drafted so that it prevents otherwise unrelated parties from entering into arrangements to exploit mismatch arrangements?**

We recommend a referral to those jurisdictions which have already implemented a GAAR.

**VII. Further Technical Discussion and Examples (questions page 69 under para 246)**

**1. Do these technical recommendations assist in understanding and applying the rules?**

We appreciate the examples given and agree that these sections are helpful. However, we would appreciate greater clarity if examples and definitions specific to banks and insurance companies were given in order that banks and insurers could better understand what could be excluded from the rules and what would continue to be considered as non-regulatory debt within the rules.

**2. Are there further technical recommendations that should be addressed in the final report?**

No comment

**Conclusion**

We hope you will find this submission helpful and would be happy to provide you with further comments.

Yours sincerely,

N. J. Lowe

Nick Lowe
Director of Government Affairs

IUA OF LONDON
INTERNATIONAL UNDERWRITING ASSOCIATION

2nd May 2014

Marlies de Ruiter,
Head,
Tax Treaties, Transfer Pricing and Financial Transactions Division,
OECD/CTPA,
Paris

**For e-mail transmission to: taxtreaties@oecd.org**

Dear Ms de Ruiter,

Thank you for inviting comments on OECD Discussion Draft on BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (treaty issues).

The International Underwriting Association of London (IUA) represents international and wholesale insurance and reinsurance companies operating in or through London. Its purpose is to promote and enhance the business environment for its members. We estimate that premium income for the London company market in 2012 was £24.225bn.

We wish to comment on the proposed changes to Article 1 of the Model Tax Convention. We consider that the inclusion of the phrase "***or arrangement***" is inappropriate and impossible to apply in practice.

The Model Tax Convention should apply only to taxpayers and not to individual transactions.

We hope you will find our comment helpful.

Yours sincerely,

N. J. Lowe

Nick Lowe
Director of Government Affairs

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***By Electronic Delivery***

2 May 2014

Achim Pross
Head, International Co-operation and Tax Administration Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development

RE : BEPS Action 2, Hybrid Arrangements, and Collective Investment Vehicles

Dear Achim,

The Investment Company Institute (ICI)[1] and ICI Global[2] urge that the Base Erosion and Profit Shifting (BEPS) Action 2 Public Discussion Drafts[3] be revised, as discussed below, to clarify the application of their recommendations to collective investment vehicles (CIVs). The only CIVs addressed by our recommendations are those that are widely-held, diversified, and subject to investor-protection regulation in the country in which the CIV is established; these CIVs invest over US$30 trillion[4] globally for their investors. We do not propose that our recommendations apply to private equity funds, hedge funds, or other types of investment vehicles.

We recommend changes to the discussion drafts for both treaty issues and domestic law recommendations. The draft on treaty issues, as discussed in detail below, should

[1] ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $16.8 trillion and serve over 90 million shareholders.

[2] ICI Global is a global fund trade organization based in London; members include regulated U.S. and non-U.S. based funds publicly offered to investors in jurisdictions worldwide. ICI Global seeks to advance the common interests and to promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets of $1.4 trillion in non-U.S. funds.

[3] http://www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf; http://www.oecd.org/ctp/treaties/hybrid-mismatch-arrangements-discussion-draft-treaty-issues-march-2014.pdf.

[4] http://www.ici.org/research/stats/worldwide/ww_12_13.

reference both the CIV report that was adopted by the OECD's Committee on Fiscal Affairs (CFA) in 2010[5] and the Treaty Relief And Compliance Enhancement (TRACE) Implementation Package (TRACE IP) that was approved by the CFA in 2013.[6]

The draft on recommendations for domestics law should provide relief for CIVs to avoid implicating legitimate financial transactions routinely engaged in by CIVs. Specifically, the recommendations should provide that (i) a CIV will be treated as a related party in a hybrid mismatch transaction only if it has actual knowledge that the requisite ownership test for related party status has been met; (ii) CIVs never will be treated as acting in concert merely because the CIVs are offered by the same investment manager, unless the CIVs have an agreement to purchase the same security in some coordinated fashion; (iii) the related party ownership threshold is increased to at least 25%; (iv) a CIV is treated as engaged in a structured arrangement only if it has actual knowledge, based on interaction with the counterparty, that the counterparty is receiving a tax benefit that outweighs the potential investment benefits to the CIV; and (v) repurchase agreements (repos) and securities lending transactions, which often constitute legitimate transactions, are not categorically characterized as hybrid mismatch transactions subject to the proposed rules.

Our recommendations are limited to the CIVs described above because these CIVs – widely-held, diversified, and regulated – have been analyzed extensively the OECD and an Informal Consultative Group it organized in 2006. The result of this examination, as mentioned above, was the CIV Report; this report discussed in detail the organization and operation of CIVs and made specific recommendations for providing treaty relief to CIVs and/or their investors.

One factor relevant to both the CIV Report and BEPS Action 2 is that, since CIVs typically calculate every day a net asset value (NAV) that is the basis for subscriptions in and redemptions of the CIV's interests, certainty regarding income and tax liability/expense is of paramount importance.

### *Support for OECD's BEPS Initiative*

As noted in our prior submission on BEPS Action 6 and tax treaty abuse (attached), we support the OECD's role in addressing on a coordinated basis various important tax concerns. We also recognize that hybrid mismatch arrangements can be a serious problem for Governments. In our view, however, CIVs almost never (if ever) would be

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[5] The CIV Report more precisely is entitled "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles" and is available on the OECD's website at www.oecd.org/tax/treaties/45359261.pdf. *See also*, http://www.oecd.org/tax/treaties/45689328.pdf (the 2010 Update to the OECD Model Tax Convention Article 1 Commentary, in which the CIV Report's recommendations were incorporated).

[6] http://www.oecd.org/ctp/exchange-of-tax-information/TRACE_Implementation_Package_Website.pdf.

involved in the types of transactions against which BEPS Action 2 hybrid arrangement recommendations should be directed.

## ***Background***

### *CIVs – In General*

A CIV is a pooled investment vehicle for providing investors with diversification and professional management. CIVs are organized as separate investment pools (often, but not always, as separate legal entities) that are owned by their respective investors. All the administrative services for the CIV are performed by a management company or another service provider. Each CIV has a specific investment objective discussed prominently in its prospectus.

A management company typically will establish multiple CIVs to achieve different investment objectives. The management company employs portfolio managers (PMs), analysts, research assistants, etc., to select portfolio securities and engage in specific transactions that are appropriate for each specific CIV. Management companies often have different arrangements for how their CIVs' portfolios are managed. Possible variations include the following: a specific CIV may have one or more PMs; one person might be a PM or analyst for more than one CIV; and/or analysts and research assistants may follow specific securities for an entire complex or provide portfolio assistance to specific CIVs.

### *CIV Portfolio Management*

The PM is responsible for making the day-to-day investment decisions for the CIV. The PM's investment decisions are guided by a fiduciary duty to the CIV's investors. Portfolio selection and transaction decisions must be consistent with that CIV's investment objectives and appropriate relative to other securities in that CIV's portfolio. CIVs typically do not invest to obtain control of a company. Domestic diversification laws typically limit a CIV's ability to own a controlling interest in a company.

The PM makes investment decisions based upon what is best for that CIV's investors. Even if the PM manages more than one CIV, the decision of whether to invest in a security is made independently for each CIV. CIVs may have different investment objectives and will hold different securities and engage in different transactions.

The PM does not buy a security or engage in a specific transaction because another portfolio manager has done so. If the management company has research indicating that a security is undervalued, each PM will decide independently whether that security provides a better value than the other securities in the CIV's portfolio. Securities are not purchased because of investment decisions made on behalf of other CIVs.

### *CIV Structures*

CIVs are structured in different organizational forms depending on local laws, cost efficiencies, and distribution arrangements. Every CIV, regardless of organizational form, operates as an investment vehicle distinct from every other vehicle.

Many CIVs are organized as stand-alone investment vehicles. Even in this simple CIV formulation, however, there are variations. Some CIVs are organized solely for distribution purposes. In this so-called "master-feeder structure," the "master" fund is the CIV in which all portfolio securities are held. The only investors in the master fund will be other CIVs (known as "feeder" funds) that are offered to investors. One benefit of the master-feeder structure is that a small financial institution can offer "its own" CIV to its customers without actually managing a CIV portfolio (which is done at the master fund level). Each feeder fund effectively is a separate pooled investor in the master fund.

Another typical CIV organizational form is the so-called "umbrella fund" or "series fund" structure. The structure is used widely because of the many organizational and operational conveniences that reduce costs and benefit investors. This structure consists of multiple "sub-funds" (the term used in Europe, among other places) or "series" (the term used in the United States) in a single fund structure. Investors acquire interests in one or more sub-funds based upon their desire for the investment objective of each such sub-fund. Each sub-fund is a separate investment vehicle (although it may not be a separate legal entity). In the United States, for example, each individual CIV that is part of a series fund is treated as a separate person for U.S. tax purposes.

*Distribution of CIV Interests*

Most CIVs in most markets rely heavily on intermediaries for the distribution of their CIV interests. In most countries, it is quite common for CIV interests to be registered on the CIV's books in the name of a distributor or a central securities depository (CSD). The CIV itself may know the identity of some of its investors. Because of the proprietary nature of the customer relationship, however, the distributor often will not share the individual investor's identity with other distributors or with the CIV itself.

The typical retail CIV will have thousands of shareholders; some CIVs will have hundreds of thousands of shareholders. CIV investors may hold their interests directly with the CIV's transfer agent. More commonly, the interests are held through an intermediary that often holds the interests in a nominee (omnibus) account. CIVs may have hundreds or thousands of intermediary distributors that hold the CIV interests for their customers.

Nominee accounts include so-called "street name" accounts set up by brokerage firms, banks, and financial planners for their customers, those held on "platforms" that are utilized by these firms, and those set up by so-called "fund supermarkets," which are created by financial services firms to invest their clients' assets in other firms' CIVs. Nominees may hold for other nominees; financial planners can hold their clients' assets in an account with another nominee, such as a fund supermarket, that will be the shareholder of record at the CIV level.

***Treaty Issues***

BEPS Action 2 Public Discussion Draft (Treaty Issues) proposes two additions to the Commentary to Article 1 of the OECD Model Tax Convention that are particularly concerning to CIVs. These additions are summarized immediately below and explained subsequently in greater detail.

Our first concern is with paragraph 26.5's statement that the Partnership Report conclusions extend to "situations that were not directly covered by the Report." This statement fails to acknowledge the conclusions reached subsequently in the CIV Report. Because the treatment of CIVs has been addressed in detail, we suggest that the phrase "(other than those involving CIVs)" be inserted between "situations" and "that are not directly covered by the Report."

Our second concern is with paragraph 26.6's statement that, if a State cannot verify whether a person is truly entitled to treaty relief, the State "might well decide to use the refund mechanism . . . even though it normally apples these benefits at the time of the payment of the relevant income." This statement fails to acknowledge the conclusions reached subsequently and reflected in the TRACE IP. Because TRACE provides Governments with assurances that treaty claims are valid and reduces the costs otherwise imposed on both Governments and business with a reclaim system, we suggest that a sentence indicating the benefits to Governments of adopting TRACE be inserted after the sentence beginning, "Also, as recognised in the Report." The penultimate sentence of this paragraph then could begin with the phrase, "If a Contracting State nevertheless cannot obtain tax information about an entity, that State . . . ."

*CIV Report*

The CIV Report was a direct result of the work done by the OECD on the Partnership Report. Specifically, an awareness arose that other vehicles, such as trusts and CIVs, presented issues in some ways similar to those raised by partnerships. This fact specifically was mentioned, during the Working Party 1 consultation with business on 17 February 2005, as the catalyst for the meeting's discussion of CIV treaty eligibility issues and the subsequent, extensive work on CIVs.

The CIV Report, as discussed in detail in our 8 April 2014 comments on BEPS Action 6, was the product of a multi-year consultation between Governments and business. The consideration given by the Partnership Report to transparent vehicles informed the CIV deliberations. Hence, there is no need, in the BEPS Action 2 context, to "extend" the Partnership Report's conclusions to CIVs. The Report's considerations already have been extended to the extent applicable.

We submit, therefore, that the CIV Report and the changes made to the Article 1 Commentary balance appropriately all relevant treaty considerations. The CIV Report's thoughtful approach for applying an LOB clause to CIVs should be reflected expressly in

the Final Report on BEPS Action 6. One approach for doing so would be to insert into paragraph 26.5 the phrase "(other than those involving CIVs)" between "situations" and "that were not directly covered by the Report." A footnote to this paragraph, similar to the one that we understand will be included in the BEPS Action 6 Final Report, would direct the reader to the CIV Report and the additional language regarding CIVs that will be added to the Commentary pursuant to the BEPS Action 2 initiative.

*TRACE Implementation Package*

The TRACE IP was a second-generation by-product of the Partnership Report. More specifically, the TRACE IP was the product of the analysis that began with CIVs and was extended to other situations in which information regarding the identity of a security's underlying owners historically has not been shared with the source country. The reason that this customer identity information has not been shared is that it is held by an intermediary; the intermediary (such as a custodial bank or a securities dealer) treats the customer's identity as proprietary (commercial) information too valuable to share with other intermediaries in the payment chain between the source country and the underlying owners.

TRACE addresses this situation, as explained in detail in the Report finalized in 2009 by the ICG organized by the OECD,[7] by allowing intermediaries to enter into legal relationships with a source country. Under TRACE, financial intermediaries make treaty claims based upon "pooled information" about treaty eligibility that rely upon information about the treaty eligibility of an intermediary's customers. The customer identity detail is provided to the source country, rather than to the CIV or to another intermediary in the payment chain, pursuant to the arrangement between the source country and the intermediary.

The ICI, ICI Global, and our members strongly support TRACE because it provides for at-source treaty relief which we submit is important to providing the certainty that CIVs require to calculate their NAVs and price their interests every day. We remain keenly interested in prompt and broad adoption of the TRACE IP.

Importantly, TRACE also provides substantial other benefits to governments, business, investors, and markets. At-source treaty relief and simplified procedures for providing governments with necessary assurances that treaty relief claims are appropriate will reduce costs for all. Compliance responsibilities will be shifted to financial institutions subject to well-developed safeguards; these institutions are in the best position, from an access and knowledge standpoint, to ensure the accuracy of investor information. Governments also will benefit from TRACE because investors will receive the withholding tax relief provided by negotiated treaties; as a result, these investors will not claim foreign tax credits (to the detriment of their residence governments) for excess tax that they

[7] http://www.oecd.org/ctp/treaties/41974569.pdf.

cannot recover. Streamlined withholding procedures also will make local markets more attractive to cross-border investment.

We submit, therefore, that the Commentary to the proposed new paragraph 2 of Article 1 of the Model Tax Convention discuss the benefits to source countries of investor certainty that are available through broad adoption of the TRACE IP. As noted above, we suggest that a sentence indicating the benefits to Governments of adopting TRACE be inserted in paragraph 26.6 after the sentence beginning, "Also, as recognised in the Report . . . ." The new sentence, for example, could state that "Adoption of the TRACE Implementation Package will allow Contracting States to receive the necessary verifications." The penultimate sentence in paragraph 26.6 then could be revised to begin with the phrase, "If a Contracting State nevertheless cannot obtain tax information about an entity, that State . . . ."

***Domestic Law Issues***

The BEPS Action 2 Public Discussion Draft (Recommendations for Domestic Laws) section on hybrid financial instruments and transfers raises three significant concerns for CIVs. Addressing fully our concerns will help prevent the BEPS Action 2 Final Report from having unintended negative consequences for the capital markets.

First, strict application of the "related persons" and "acting in concert" rules that are proposed in the Public Discussion Draft would inadvertently implicate routine investments by CIVs. These transactions do not give rise to the policy concerns that BEPS Action 2 is intended to address. Application of these rules, however, would have detrimental effects on CIVs and their abilities to manage their portfolios effectively.

To address these concerns, as discussed in detail below, we urge the following modifications to BEPS Action 2. First, we urge that the proposal treat a CIV as a related party engaged in a hybrid mismatch transaction only if the CIV has actual knowledge that the requisite ownership test for related party status has been met. Second, we urge that CIVs never should be treated as acting in concert merely because the CIVs are offered by the same manager. The acting in concert standard should be met only if the CIVs have an agreement to purchase the same security in some coordinated fashion. Finally, the minimum threshold interest for related party status should be raised from 10% to at least 25%.

Second, we have the same concerns that strict application of the "structured arrangement" readily identifiable factors would have detrimental effects on CIVs. In particular, we are concerned about the "pricing" factor and the "tax-indifferent accommodation party" factor. The price at which an instrument trades, almost by definition, reflects all factors (including tax) that affect the investment return. Moreover, a CIV owned exclusively by tax-exempt investors (such as pension funds) might be considered "tax-indifferent." We urge clarification that CIVs will be treated as engaged in a structured arrangement only if they have actual knowledge, based upon interaction

with their counterparty, that the counterparty is enjoying a tax benefit from the transaction that outweighs the potential investment benefits to the CIV of the transaction.

Finally, the Public Discussion Draft suggests that cross-border repurchase agreements ("repos") and securities lending arrangements are inappropriately tax-motivated. CIVs, as discussed below, enter into these transactions for legitimate investment or hedging purposes. Repos and securities lending are not *prima facie* aggressive tax planning transactions. One of the reasons that we support a bottoms-up approach to hybrid transactions is that CIVs generally will be effectively exempted from hybrid treatment with respect to their legitimate use of these arrangements, so long as transactions that are readily available in the commercial markets are not treated as ones in which parties are treated as acting in concert to take advantage of hybrid mismatches.

*Related Persons and Acting in Concert*

We urge, as noted above, that the "related persons" and "acting in concert" rules be modified before the BEPS Action 2 Final Report is issued. The rules proposed in the Public Discussion Draft would inadvertently implicate routine investments by CIVs even though these transactions do not give rise to the policy concerns that BEPS Action 2 is intended to address.

First, the proposed rules should treat a CIV as a related party engaged in a hybrid transaction only if the CIV has actual knowledge that the requisite ownership test for related party status has been met. Because many CIV investors hold their shares through an intermediary, as discussed above, the CIV likely will not know the identity of a substantial portion of its investors. Therefore, the CIV will not have sufficient information to determine that it is "related" to the counterparty under the proposed definition. Requiring CIVs to collect or analyze information about their investors and/or the other investments held by these investors is impossible as a practical matter. Moreover, requiring CIVs to disclose their portfolio holdings on a current basis, so that the CIVs' investors or the issuers of the CIVs' portfolio investments could determine whether a related party situation existed would be equally problematic. If others were informed of a CIV's investments, they could trade on that information to the detriment of the CIV and its investors.

Under the proposed rules, it is possible that a CIV unknowingly could enter into a routine financial transaction with an institutional investor that, under this proposal, is a related party, thus causing the transaction to qualify as a hybrid financial instrument or transfer. The institutional investor itself likely will not know that the parties are related. Because these transactions are entered into by the parties for legitimate non-tax reasons, they should not be implicated by the proposed rules simply because the CIV and the counterparty have unknowingly become related persons. Therefore, CIVs should be exempt from the hybrid mismatch rules, except in the unlikely case of structured

transactions where the CIV has actual knowledge that the counterparty is a related person.

It is also important to note that in the "master-feeder" structure, for example, one CIV may hold as much as 100% of another CIV. Although the related funds would not engage in financial transactions with one another, it is possible that transactions by either fund with a third party could fall within the related persons rule, especially given the low threshold for determining ownership. The complex organizational structures would make tracking of such relationships across a fund complex incredibly burdensome. Providing an exception to the related persons rule for CIVs without actual knowledge of a relationship would resolve this problem.

Second, we urge that CIVs never should be treated as acting in concert merely because the CIVs are offered by the same manager. The "acting in concert" standard should be met only if the CIVs have an agreement to purchase the same security in some coordinated fashion.

Paragraph 128 notes that parties that have entered into "shareholders or voting agreements, joint venture and private equity funds under the control of a common manager all raise relationship issues" similar to those raised by related parties. The proposed rule provides that two persons will be treated as acting together in respect of ownership or control of any voting rights or equity interests if, among other things, the ownership or control of any such rights or interests is managed by the same person or group of persons. This definition could apply to CIVs offered by the same investment management company. Though the investment manager may not have any equity interests in the CIVs, the investment manager does "manage" the investments held by the CIVs. If these CIVs are deemed to be related persons, equity interests held by one CIV could be aggregated with those held by the other CIV, causing the CIVs to be "related" to a common issuer. Thus, any transactions entered into by either one of the CIVs with the common issuer could be deemed hybrid financial transactions.

CIVs offered by the same investment management company should not be deemed to be acting in concert under this proposal. As discussed above, the CIVs have different PMs with separate fiduciary duties and investment objectives. The CIVs' purchases in common issuers will not be coordinated or aimed at a particular tax outcome. Requiring CIVs to assess the holdings of other CIVs with the same investment manager before entering into financial transactions would be incredibly burdensome and provide little, if any, benefit. Therefore, the proposal clearly should carve out from the "acting in concert" rule CIVs with a common investment management company, unless it is clear that the funds truly are taking coordinated action.

Finally, the minimum threshold interest for related party status should be raised from 10% to at least 25%. The Public Discussion Draft recognizes, in paragraph 127, that funds may have investors with ownership interests that exceed 10% but believes these "non-

portfolio investors" should be sufficiently aware of their ownership interest to comply with the hybrid mismatch rules.

In general, CIVs do not have many investors with more than a 10% ownership interest. This does not mean, however, that such investors do not exist. There are numerous situations in which a particular investor may hold an interest that is greater than 10%. For example, daily redemptions may decrease the size of a CIV, causing an existing investor's percentage ownership interest to increase. Also, a newly formed fund may have investors with larger interests (including "seed money" contributed by the investment management company to allow the CIV to begin operations). The mere fact that an investor holds an interest of 10% or more does not create a significant relationship between the investor and the CIV. For the investor, particularly if it is an institutional investor, the stake in the CIV may be relatively small in comparison to the investor's entire portfolio.

We believe that a higher threshold should be used to determine whether parties are related. We submit that a threshold of at least 25% is more likely to capture the types of transactions about which the OECD is concerned without overly burdening CIVs and their portfolio investors.

Financial transactions entered into by CIVs typically do not give rise to the concerns raised in the BEPS Action Plan. Therefore, CIVs generally should be excluded from the proposed rules on hybrid mismatches; they should be included *only* when a CIV has actual knowledge that it is party to a structured transaction with a related person. If, however, the OECD still is concerned about hybrid mismatches in the context of CIVs, we submit that it consider the United States rules addressing the extent to which related entity rules might be applied to CIVs. Specifically, U.S. Treasury Regulations, in the context of rules that limit losses when there is an ownership change involving "5-percent shareholders," define an "entity" to include "a group of persons who have a formal or informal understanding among themselves to make a coordinated acquisition of stock. A principal element in determining if such an understanding exists is whether the investment decision of each member of a group is based upon the investment decision of one or more other members."[8]

It is clear from the examples in the Treasury regulations that clients acting on a recommendation of an investment advisor are not making a coordinated acquisition because each client's decision was not based upon the investment decision made by one or more other clients. The result is no different if the trustee of several trusts causes each trust to purchase a company's stock, so long as the investment decision made on behalf of each trust was not based on the investment decision made on behalf of one or more of the other trusts.

[8] Treasury Regulations §1.382-3(a).

The examples in the Treasury regulations have been extended in Internal Revenue Service private letter rulings to situations involving CIVs. Specifically, the rulings provide that two or more CIVs will not constitute an entity within the meaning of the regulations merely because: (a) the same corporation acts as investment manager to the CIVs; (b) the same corporation votes the securities purchased on behalf of the CIVs; and/or (c) the CIVs have the same board of directors. This guidance should be applied as well to the definition of related entity in BEPS Action 2.

Any other result could disrupt the capital markets. Issuers should be concerned that their otherwise-appropriate interest deductions could be limited if CIVs organized by the same investment management company hold 10% or more of the issuer. In addition, the operational challenge of tracking ownership by multiple CIVs would be extremely difficult. Aggregation would make no sense, we submit, if one CIV is buying while the other is selling. Aggregation also would be inappropriate if the CIVs acquired their interests at substantially different times.

The purpose of each independent acquisition of a security is to benefit from the income arising from the security and/or appreciation in the security's value. So long as there is no plan, aggregation is inappropriate. The substantial burden of developing systems to aggregate the holdings of different CIVs is justified only if the PMs are acting in concert.

*Structured Arrangements*

The discussion of structured arrangements also raises concerns regarding financial transactions routinely engaged in by CIVs. Paragraph 131 lists five factors that could be considered in determining whether an arrangement is "structured." These include (i) whether the pricing of the arrangement took in account sharing of the tax benefit or the expected tax benefit of a hybrid mismatch; and (ii) whether the arrangement involves tax-indifferent accommodation parties or special purpose vehicles. The Public Discussion Draft notes that the list of indicators is being explored further.

The use of these two factors, alone or together, to determine whether a structured arrangement exists are troublesome for CIVs, as they may be present in many legitimate transactions utilized by CIVs. We understand the desire for a comprehensive objective test but ask the OECD to consider the implications for transactions that do not raise BEPS concerns. For instance, looking at whether the pricing of the arrangement reflects any tax benefit to either party may not effectively eliminate transactions that should not be included in the hybrid mismatch rules. The price at which an instrument trades, almost by definition, reflects all factors, including tax, that affect the investment return. Thus, this factor is overly broad and could draw in transactions that are effected for legitimate non-tax reasons. Requiring CIVs to apply the hybrid mismatch rules could have a chilling effect on their ability to invest in the capital markets.

Further, considering whether a transaction involves a "tax-indifferent" party could implicate a CIV owned exclusively by tax-exempt investors, such as pension funds. These

CIVs, like all other CIVs, enter into various financial transactions for legitimate investment purposes; the fact that the CIV's investors are not subject to tax in their home country should not be considered alone in determining whether a transaction is a structured arrangement. The possibility that the participation of a CIV with tax-exempt investors could cause a transaction to be deemed a structured arrangement could inhibit these CIVs' abilities to invest in the markets, disadvantaging their investors.

It is highly unlikely that a CIV would enter into a true structured arrangement. The indicators set forth in the Public Discussion Draft, however, could cause legitimate transactions by CIVs to be deemed "structured arrangements" under the hybrid mismatch rules, even though these transactions do not give rise to the tax policy concerns addressed by BEPS Action 2. Given the possible detrimental effect of applying these factors in the CIV context, CIVs should be treated as engaged in a structured arrangement only if they have actual knowledge, based upon interaction with their counterparty, that the counterparty is enjoying a tax benefit from the transaction that outweighs the potential investment benefits to the CIV of the transaction.

*Repos and Securities Lending*

The Public Discussion Draft specifically identifies repos and securities lending transactions as hybrid financial transactions that can result in a mismatch in tax outcomes, lowering the aggregate tax burden for the parties to the arrangement. Although there certainly are examples of repos and securities lending transactions that do so, such transactions are not *prima facie* aggressive tax planning techniques. Moreover, repos and securities lending transactions are important sources of liquidity for the markets. Consequently, they should not be treated as *prima facie* aggressive tax planning techniques in the BEPS Action 2 Final Report.

CIVs routinely enter into repos and securities lending transactions for legitimate, non-tax purposes. For example, CIVs use repos as a cash management tool. As such, they often enter into repos at the end of the day to receive a return on any excess cash. If there is a concern regarding the use of cross-border repos, the solution is for domestic law to treat the transaction in accordance with its substance – which is a secured financing – rather than as a sale. CIVs also often enter into securities lending transactions, pursuant to which a fund loans its securities to other parties, to increase the return on those securities. Applying the proposed hybrid mismatch rules to these transactions could inhibit CIVs' abilities to effectively manage their portfolios.

Given the many important market-beneficial non-tax reasons for using repos and securities lending transactions, the BEPS Action 2 Final Report should state clearly that such transactions are not *prima facie* structured transactions that give rise to mismatches in income. The Final Report also should clarify that the hybrid mismatch rules apply only when the repo or securities lending transaction is specifically structured to take

advantage of any hybrid tax treatment. Transactions that are readily available in the commercial market should not be subject to the proposed rules.

* * *

These issues are critically important to the global CIV industry. Our recommendations, we submit, are fully consistent with sound tax policy.

Please feel free to contact us (at lawson@ici.org or 001-202-326-5832 or at kgibian@ici.org or 001-202-371-5432) at your convenience if you would like to discuss this issue further or if we can provide you with any additional information.

Sincerely,

Keith Lawson
Senior Counsel – Tax Law

Karen Gibian
Associate Counsel – Tax Law

Attachment

cc: Kate Ramm
John Peterson
aggressivetaxplanning@oecd.org

Investment Management Association

ima

2 May 2014

Achim Pross
International Co-operation and Tax Administration Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development

By email: aggressivetaxplanning@oecd.org

Dear Achim

**OECD DISCUSSION DRAFT ON BEPS ACTION 2**

IMA[1] recognises the importance of combating tax avoidance, abuse and aggressive tax planning, and we support the objectives of the BEPS Action Plan.

As you know, our primary concern is that, in the efforts to deal with the different challenges of combating tax abuse, each of the plan's Action Points will have a distinct impact on the tax treatment of CIVs and their investors. We believe that the approach to CIVs in BEPS should be done within an overall package and a coherent framework if it is to be manageable for CIVs and their managers, and if adverse consequences for the market for CIVs and for their investors are to be avoided.

We believe there is an inherent link in many of the initiatives currently being considered by the OECD. In particular:

- The recommendation in Action Point 2 to establish requirement to report income and gains to investors and/or tax administrations
- The recommendation in Action Point 6 to apply limitation on benefits to tax treaties – which requires CIVs to have greater knowledge of their investors and their tax treatment
- The TRACE project, which requires the reporting of information on taxpayers to source countries
- AEOI, which requires the reporting of information on taxpayers to resident countries.

[1] IMA represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of around $5.4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles.

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The common theme is transparency of information and reporting: to investors, resident, and source tax administrations.

As you are aware from the work the OECD has done on AEOI, a key risk to business is the proliferation of different regimes for information gathering, due diligence and reporting. The downside is not only additional cost for businesses, but also confusion for consumers of financial products, and barriers to accessing financial products.

We are grateful for the opportunity to comment on the discussion draft on Action 2, and we are grateful for the recognition that special rules are required for CIVs, and that the scope of the rules in relation to hybrid financial instruments is limited to non-portfolio investments.

Our comments are limited to three points: the recommendation for the establishment of foreign investment fund reporting rules, and the related persons test, and a purpose test.

## Foreign investor fund reporting

There are currently a number of countries that operate regimes that are designed to prevent investors from being able to accumulate income in offshore funds, whether or not hybridity is a factor in the accumulation. Such regimes operate in the UK, Germany and Austria, for example.

We would welcome an approach that could serve to harmonise all such reporting regimes. The multiplicity of reporting regimes is complex, and costly to operate for funds that are distributed internationally, and this would be of great benefit to the funds industry.

We note that a common feature of these regimes is that they are operated by the residence country, and not the intermediary (fund) country. As is the recommendation of the discussion draft, an internationally harmonized reporting regime should be operated by the fund jurisdictions and we would welcome such an approach if applied consistently.

A further common feature of the current regimes is that information is reported to the investor. Whilst we acknowledge that tax administrations may have an interest in this information, we strongly believe that the focus on reporting to tax administrations should remain within the scope of the work on AEOI. Any parallel development for the purposes of combating hybrid arrangements in funds would duplicate costs for no additional benefit. We also note that hybridity is not a key risk associated with fund investment, but instead the key risk to tax administrations is the deferral of tax on income.

Equally, we note that superimposing CFC rules and fund reporting rules creates overlapping tax burdens and can result in double taxation for fund investors. Therefore we urge you to consider whether this recommendation should have consequences for funds in the future consideration of CFC rules in Action Point 3.

## Related persons test

We believe the related persons test is very narrowly drawn and would capture many arrangements in which the issuer and investor are, commercially, unrelated.

The 10% threshold, in particular, seems unnecessarily low. We believe that incorporating the concept of control to determine whether a person is related would result in more equitable and simple application of the rule.

In the context of investment management, the recommendations on defining persons acting in concert would result in an investment manager that takes decisions independently in respect of each of the funds it manages to consider the overall position over an entire range of funds.

Many investment managers are large organisations employing hundreds of staff involved in the process of stock selection. Often they manage many funds, frequently hundreds of them. The process of monitoring assets over a whole range of funds, where positions change daily, and understanding within all these investments whether a particular position in a fund results in a range of funds owning collectively more that 10% of an investment seems unimaginably complex.

The proposal undermines a fundamental principle of investment management – that funds and their managers are not the same person and are related only by contractual arrangements. In practice and legally, it is never the case that funds are related persons only on account of sharing the same investment manager.

We urge you to consider redrafting the provision on acting in concert to take into account that management of an investment portfolio, or of funds cannot result in the funds being considered to be acting in concert.

## Purpose test

We understand the appeal of a mechanical and automatic application of the hybrid rules, but we are concerned about any potential unintended impact on fund structures. The discussion draft states that a purpose test "will generally be unnecessary, however, in the context of a multilateral approach that is designed to eliminate the mismatch in tax treatment regardless of where the tax benefit arises". We believe that a purpose test can serve to eliminate the risk that the rules apply in situations where there may be justifiable commercial grounds for a mismatch.

Moreover in the context of a multilateral approach, such a test could be drafted to apply irrespective of where the tax benefit is derived.

We hope to be able to continue to contribute to the consultation and I am available at your convenience to discuss anything in this letter at jmorley-smith@investmentuk.org or on +44 (0)20 7831 0898.

Yours faithfully,

Jorge Morley-Smith
Director, Tax

Cc. Mike Williams, HM Treasury

Dr. Achim Pross,
Head, International Co-operation and Tax Administration Division
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2, rue André Pascal
75775 Paris Cedex 16

***By email:*** aggressivetaxplanning@oecd.org

2 May 2014

Dear Sir,

**Re: OECD Base Erosion and Profit Shifting (BEPS) plan: *Action 2 – hybrid mismatch arrangements***

We welcome this opportunity to provide comments on the draft documents for discussion released on 19 March 2014 on hybrid mismatch arrangements.

The Irish Debt Securities Association ("IDSA") is an Irish industry organisation established to promote and develop Ireland as a European location for activities to support the global structured finance, debt securities and specialist securities industries. IDSA strives to promote a responsible, sustainable and effective environment within which debt securities and other specialist securities can be used to facilitate transactions, to create investment products and to raise capital funding.

The membership of IDSA includes corporate administrators, trustees, audit firms, legal advisors, listing agents, and other parties involved in the structuring and management of special purpose vehicles in Ireland. The IDSA works to promote high standards of professional conduct among industry service providers and to lead industry activity in developing and providing a world-leading environment for structured finance transactions and for the issuance of debt securities and other specialist securities.

Securitisations, structured finance, debt securities and other specialist securities ("securitisations") play a key role in bridging the gap between financial markets and capital markets and in providing access to non-bank sources of finance in order to fund investment. In light of the recent global banking crisis, securitisations represent an important alternative to bank finance by providing access to debt in capital markets – access which is particularly important for capital intensive industries.

The European Central Bank (ECB) has recognised the vital role played by the securitisation industry in providing access to non-bank finance for business generally, its capacity to revitalise financial markets

in the wake of the euro-zone banking crisis and to address the historic over-reliance on bank funding in Europe. For example, the ECB has recently endorsed a proposal to repackage loans to small and medium-sized enterprises into standardised products that are easier for rating agencies to assess and for investors to price.

Given the importance of securitisations to the effective working of global financial markets, IDSA welcomes the opportunity to outline its view on the proposals set out in the OECD discussion drafts on hybrid mismatch arrangements.

1. We agree that to be effective, a multilateral approach is required for measures targeted at hybrid mismatches. Jurisdictions should not act unilaterally to implement the proposals until it has become clear that a co-ordinated approach is being adopted and further that there is clarity on the implementation of the proposals in counterparty jurisdictions. We recommend that the OECD monitor the introduction of agreed measures by jurisdictions and that implementation should be deferred until there is an appropriate number of jurisdictions adopting the new measures. This should limit the uncertainty that will likely arise from the implementation of the measures.

   We strongly agree that the design principles underpinning the proposals should be that they are workable for taxpayers and are easy to administer. We consider that the automatic application of provisions in domestic law could potentially be more efficient for both taxpayers and taxing authorities but this could only work where a targeted approach is adopted in the implementation of anti hybrid measures in domestic law. The measures should be narrowly crafted and tailored solely to address those aspects of domestic law that are capable of exploitation in specific hybrid mismatch arrangements. We therefore consider that the 'bottom-up' design approach is more appropriate.

   The implementation of measures in domestic law related to hybrid instruments by adopting a top down, general approach is likely to lead to uncertainty and complexity in the application of the provisions. It may lead to risk of double taxation in instances where two jurisdictions implement a top-down approach in their adoption of local measures but frame their local exceptions from the measures in different ways.

   Irish experience of implementing domestic measures to safeguard against hybrid mismatches in the context of securitisation activities has shown that the introduction of targeted measures has proven effective and workable for both taxpayers and tax authorities. Targeted measures should, more broadly, pose less risk of creating uncertainty in their application. They should also pose less risk of having an unintended effect on the overall framework of the domestic tax regime and its application to debt issuance activities.

   Uncertainty in the treatment of cash flows is a particular cause of concern in securitisation transactions and debt raising transactions generally. They rely on certainty and stability in the treatment of cash flows. These factors underpin the efficient credit rating of different tranches of debt and provide investors with reliable information on the expected cash flows that fund the obligations of the debt issuance vehicle. Also, the debt capital markets expect a securitisation vehicle to be largely "tax neutral" (and for taxation to arise at investor level), and it would be regrettable of course if any changes were to result in a change of location of securitisation vehicles out of OECD countries to non - OECD countries.

   Even where measures are targeted, our experience suggests that detailed guidance for taxpayers is still required in order for the provisions to operate effectively, e.g. guidance is

provided on the application of 'subject to tax' requirements in the case of common structures adopted by international investors.

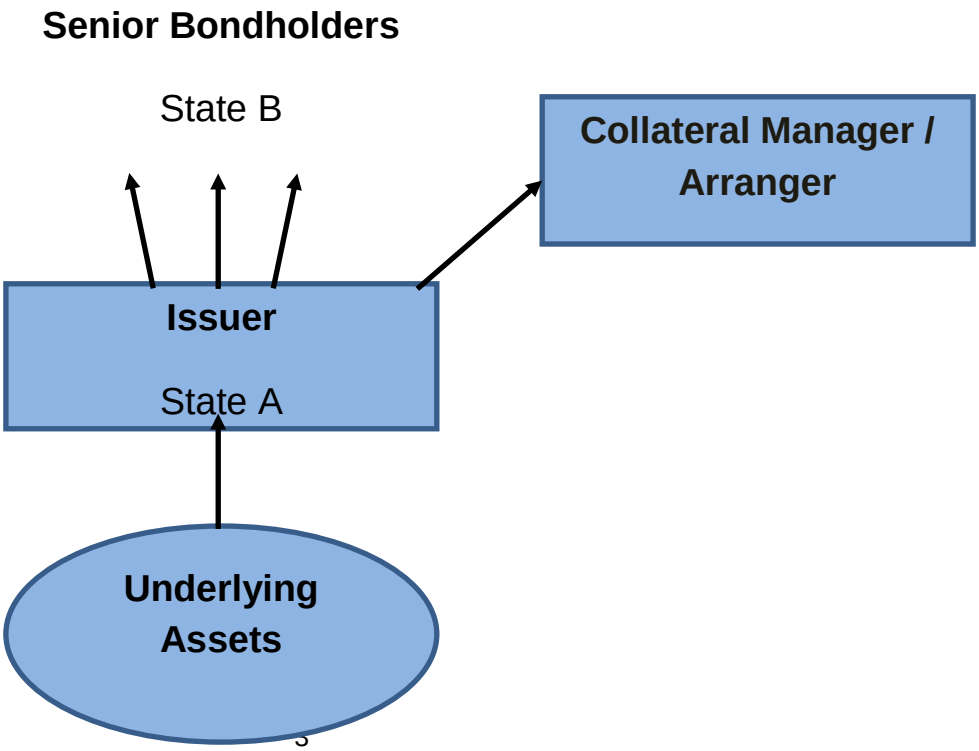
2. In the case of the proposed hybrid instrument measures, the primary measure to counteract the effect of a hybrid mismatch is focused on the debt issuer and serves to deny a deduction from taxable profits of the borrower for a payment made under a hybrid instrument. The proposed measure places the burden of knowledge on the debt issuer to ascertain the tax status of the investor. This information will not be available or readily obtainable in many typical transactions.

We consider that the scope of the hybrid instrument measures should be confined to "related party" transactions which are the true target of the BEPS project. In a related party scenario, it can be more reasonably expected that the debt issuer will have insight into the tax position of the debt counterparty. This is especially the case for listed instruments in bearer form where the issuer cannot be expected to have information on the tax position of the counterparty.

If the scope of the measures is applied too widely, the burden of compliance with the proposals can be expected to result in additional costs for issuers and uncertainty for investors. They can be expected to have an adverse impact on the operation of debt issuance activities across financial markets.

We would strongly urge the OECD to conduct an in-depth analysis of the effect of the measures on financial markets before seeking to recommend the implementation of measures that apply to transactions between unrelated parties. We have grave concerns that they would prove inoperable in practice.

3. Furthermore, in a typical securitisation or structured product issuance structure, the denial of a deduction from taxable profits of the borrower for payment made under a bond which is intended to sweep up the excess income of the issuer (the "Retention Note") can result in an unintended outcome as illustrated by the following example:



A debt issuer (the “Issuer”) resident in State A issues debt to senior bondholders resident in State B with the Retention Note held by either the collateral manager or the originator/arranger (the “Retention Holder”) resident in State C. A number of EU directives and regulations (such as Regulation (EU) No. 575/2013 (the "CRR"), EU Directive 2011/61/EU on Alternative Investment Fund Managers ("AIFMD"), the forthcoming directive known as Solvency II and the level 2 measures adopted under Directive 2009/65/EC on Undertakings for Collective Investment in Transferable Securities (the "UCITS Directive")) have the effect of requiring EU securitisations to include Retention Notes of a particular value (usually 5% of the nominal value of the securitised exposures or of the tranches sold to investors). The Retention Notes must be held by the manager or the originator of the securitisation to expose the manager or the originator to the risk of non-performance of the underlying assets. Clearly these hybrid instruments are issued for good regulatory reasons and not for tax avoidance. As a result they should fall outside any anti-hybrid measures. The Issuer uses the proceeds of the debt issuance to purchase underlying assets in State D.

(i) If the Issuer is denied a deduction on payments to the Retention Holder on the Retention Note, then profits are taxed in State B and often there is a participation exemption available in State C which exempts the receipt of such payments in State C from tax. In summary tax is payable in State B but not in State C which is an odd result.

(ii) If the Issuer can deduct the payments to the Arranger then the Issuer is tax neutral and the Retention Holder should be and usually is taxed in State C where it generally has its operations. In summary tax is payable in State C but not in State B.

This is the most common securitisation structure and the intended outcome described in paragraph (ii) (rather than that described at paragraph (i)) should arise. If it does not then countries in which substance is located will have their tax base eroded.

4. We consider that in the case of the hybrid instrument proposals that the 10 percent ‘ownership’ threshold for application of the “related party” definition is too wide. There be a higher percentage ownership applied such that it can be more reasonably expected that one counterparty will have sufficient degree of common ownership and influence to be in a position to understand the tax status of the other counterparty to the instrument. We suggest that it should be set at a minimum of 50 percent ownership i.e. a controlling interest.

5. In investigating whether the counterparty meets the requisite threshold for ownership, it should be clear that the borrower should not be required to pursue information which, in good faith, is neither already within its possession or awareness nor relevant to the determination of a controlled ownership interest.

6. The definition of ‘equity interests’ at paragraph 128 which are used to determine the ownership criteria for “related party” transactions is also cast very widely and potentially includes a range of commonly occurring lending arrangements which are found in securitisation and secured financing transactions. The definition includes “any interest in a

person that includes an entitlement to profits". This definition potentially includes asset backed debt where the returns paid on the debt instrument to investors track the performance (including profits) of a pool of underlying assets held by the debt issuer. They might also include loans advanced under secured lending arrangements where the borrower's obligations to repay debt are limited to the cash flows from the assets funded by the debt.

The terms of these arrangements are designed to provide the investor/lender with an 'ownership' exposure to the underlying assets and not to the debt issuance vehicle, where the contracting party to the loan is the debt issuer. These common commercial lending arrangements are just some instances of loans which should be excluded from the definition of 'ownership' relationship between lender and borrower where no other economic 'ownership' interest exists.

7. We consider that the scope of the proposals for hybrid entity and reverse hybrid transactions should also be confined to related party transactions on the additional assumption that "related party" is defined by reference to a controlling 50%+ interest.

8. We consider that the multi factor approach which is outlined to apply the proposed measures to 'structured transactions' between unrelated parties is likely to lead to uncertainty of application and cause complexity for both taxpayers and taxing authorities. The proposals suggest that 'structured transactions' can be defined by the adoption of a range of identifier factors. However, the adoption of a range of factors into local law in a manner that is tailored to the domestic legislation of each implementing jurisdiction is likely to lead to multiple interpretations of the factors across jurisdictions and to lead to complexity and uncertainty in their application for investors.

Further work needs to be done in framing the secondary and 'defensive' measures which are intended to operate for hybrid entity and reverse hybrid structures where the primary proposed measures are not enacted in the investor jurisdiction. As currently proposed, the measures could impose an obligation on a securitisation vehicle which is the end borrower to investigate the holding structure and the tax status of investors throughout the life of the vehicle while returns are being paid on debt issued by the vehicle. It can be seen that this is likely to place an undue burden of compliance on debt issuers which are open ended vehicles in which there are regular changes in the investor profile. In our experience, meeting this requirement may not be workable even in the case of a close ended structure because the relationship between investors holding different classes of debt instrument in the vehicle may not remain constant throughout the life of the vehicle. We suggest that these measures should be focused solely at the level of the investor jurisdiction or should include a 'carve out' for collective investment vehicles engaged in securitisation activities.

The proposed measures on hybrids can be expected to overlap with measures under review in other Actions of the BEPS Plan. In particular, Controlled Foreign Company measures (Action 3) will be expected to have an impact on the potential use of hybrid entities by taxpayers resident in 'investor' jurisdictions and this may be a better route for tackling these types of hybrids.

Investors in securitisation transactions may hold their interests through layers of intermediary holding structures which are designed to pool together smaller investors and streamline the management of the underlying debt cash flows. Some of the proposed secondary and 'defensive measures' targeted at hybrid entity and reverse hybrid structures

would seek to fundamentally broaden the scope and territoriality of taxing regimes e.g. where they suggest that jurisdictions should recognise a taxable presence where there is none under current law or should treat legal arrangements such as partnerships as non-tax transparent entities.

We have concerns that these proposals go beyond what is merited in the context of targeting BEPS transactions as they require fundamental changes to the scope of taxation in jurisdictions. They can be expected to add great complexity and uncertainty to the tax treatment of existing and commonly used securitisation structures which seek to pool investors from multiple jurisdictions. We suggest that these measures should be dealt with solely at the level of the investor jurisdiction and should not extend to the 'intermediary' and debt issuer jurisdictions.

IDSA thanks the OECD for the opportunity to outline the views of its members on the extensive and detailed draft discussion papers and would be pleased to elaborate on the issues raised in this submission if required.

Yours faithfully,

**GARY PALMER**
**Chief Executive**

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Document No. 42
May 2, 2014

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

Accounting & Tax Committee
Japan Foreign Trade Council, Inc.

**Comments on Discussion draft on**
**Neutralise the effects of hybrid mismatch arrangements**

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) in response to the invitation to public comments by the OECD regarding the "Discussion draft on Neutralise the effects of hybrid mismatch arrangements".

The JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of JFTC's Accounting & Tax Committee is to submit specific policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

## Overall Comments

1. Schemes designed to utilise hybrid elements in the tax treatments of financial instruments and entities in order to create double non-taxation generally lack transparency and undermine fair competition among companies. Therefore, we support OECD initiatives aimed at the realization of BEPS Action 2.

2. The proposed hybrid mismatch rule does not question the appropriateness of tax treatment under the laws of each country. Instead, the rule is to be applied to the mismatches that arose under the present system, by automatically following the steps. While the concept is straight forward, actual compliance burden will be complicated. First, hybrid mismatch rules differ by type of hybrid mismatch arrangements. And second, tax treatment in counterparty jurisdictions needs to be confirmed for each transaction. If the scope of application of the rules were to be excessively broad, in certain situations it would prove difficult to obtain information pertaining to the details of transactions and tax treatment in counterparty jurisdictions, which will undermine predictability for taxpayers. Therefore, we request that due attention be paid to

predictability for taxpayers and compliance cost when determining the scope of application of the rules.

3. Hybrid mismatch rules should be formulated to avoid situations giving rise to double taxation. Possibilities include simultaneous denial of deduction or inclusion in income for the same transaction by multiple jurisdictions due to inconsistencies in domestic laws, and differences in enforcement of complex linking rules by tax authorities. Excessive focusing on the elimination of double non-taxation may unwittingly generate double taxation. This Public Discussion Draft should emphasize the importance of avoiding such outcomes.

4. Hybrid mismatch rules are closely interrelated with Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments), and Action 14 (Make dispute resolution mechanisms more effective). Therefore, the details of the final proposal and the timing of its introduction should be coordinated with these Actions. In addition, we request that the amendments to domestic laws pursuant to Action 2 to be disclosed to taxpayers well in advance.

**Specific Comments**

***Recommendations for Domestic Laws***

**Paragraph 103**

The scope of mismatch and measures to eliminate its effects are left to domestic law implementation and administrative guidance, and it is further stated that complexity should be avoided. In addition to this, it should be emphasized that double taxation should not be permitted to arise from inconsistencies in the tax laws and enforcement practices of various countries.

**Paragraph 108**

The administrative burden of the taxpayers and effectiveness should be taken into considerations when determining required preciseness of the calculation for the partial denial of exclusions from income or deductions.

**Paragraphs 119 and 120**

A bottom-up approach and a top-down approach are presented as methods for identifying hybrid financial instruments. We are concerned that if the scope of the top-down approach were allowed

to become too extensive, this would give rise to difficulties in obtaining information pertaining to the details of the transaction and tax treatment in the counterparty jurisdiction, and would increase an administrative burden on taxpayers. Therefore, in view of predictability and compliance cost, we believe a bottom-up approach should be adopted. If a top-down approach were to be adopted, the scope of application should be clearly defined, and no room should be left for arbitrary interpretation by tax authorities.

Paragraph 128

A related person is defined as a person with a 10 percent or greater investment in another person, either directly or indirectly. It is, however, not easy to confirm tax treatment in a counterparty jurisdiction when the shareholding is only 10 percent. In view of predictability and compliance cost, we believe "10 percent or greater" should be changed to "more than 50 percent."

Paragraphs 131 and 132

Paragraph 132 states that the list of indicators for a structured arrangement is being further explored. The latter part of the paragraph states, "This approach also necessitates a more detailed examination of the circumstances of each arrangement and an identification of factors which may not be evident from the terms of the transaction documents themselves." Regarding the list of indicators to be identified as a result of the abovementioned process, it is desirable for these to be specific and concrete indicators so as to preclude arbitrary judgment.

Paragraphs 180–183

The example of hybrid entity payments given in the Public Discussion Draft entails 100-percent ownership of a hybrid entity by an investor. However, it is also possible that a multiple number of investors residing in different jurisdictions jointly own a hybrid entity. Even when investors residing in a certain jurisdiction are able to choose treating the hybrid entity as a taxable entity, the possibility remains that investors residing in other jurisdictions may not be able to make a similar choice. We believe that due attention must be paid to the elimination of double taxation in light of this possibility.

Paragraphs 190, 191, and 193

Depending on whether the primary rule or secondary rule is applied, the country in which a deduction is denied will differ. This can be expected to give rise to differences in carry-forward period of a denied deduction. We contend that there is a room for argument if a taxpayer's tax position differs according to the rule that is applied. In regard to a deduction/no-inclusion

structure referred to in paragraph 193, this paragraph states that carry-forward of payments that have been denied deduction is not permissible. We request that this statement be clearly explained in light of the disparity with statements made regarding a double deduction structure referred to in paragraphs 190 and 191.

**Paragraphs 219 and 221**

The amendment of controlled foreign company (CFC) rules is requested in the primary rule. It should be developed with due consideration given to the relation with Action 3 as stated in paragraph 221.

**Paragraph 224**

As a defensive mechanism against imported mismatches, paragraph 224 recommends denial of deduction in the payer's country of residence, which is a third country. However, expanding the scope of hybrid mismatch rules to cover a payer's country of residence that is completely unrelated to the hybrid arrangements heightens the possibility of denial of deduction in the country of residence of the payer even if the transaction in question involves no mismatch. We contend that this will undermine stability in tax administration.

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April 28, 2014

Secretariat
Committee on Fiscal Affairs
Organisation for Economic Co-operation and Development

**Comments on the Public Discussion Draft on BEPS Action 2**
**(Neutralise the Effects of Hybrid Mismatch Arrangements)**

Keidanren hereby submits its comments on the Public Discussion Draft "BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements" published by the OECD on March 19, 2014.

1. Abusive arrangements that exploit differences among countries in the tax treatment of entities and financial instruments are one of the reasons why base erosion and profit shifting (BEPS) has become a concern of the international community. Neutralizing the effects of such abusive hybrid arrangements is of paramount importance to preventing the erosion of the tax base of each country and ensuring a level playing field for companies. Keidanren supports the OECD's initiatives to establish concrete rules based on BEPS Action 2.

2. When creating concrete rules for preventing tax avoidance, due consideration needs to be given to ensure that the new rules will neither hamper normal business activities nor impose excessive administrative burdens on taxpayers and tax authorities, as pointed out in our comments concerning the public discussion drafts on other BEPS Actions.

3. From that perspective, we believe that the contents of this Public Discussion Draft require further examinations on whether there is a consistency between the ends and the means, as is the case with the rules already proposed based on other Actions.

4. As a measure of neutralizing the effects of hybrid mismatch arrangements, the Public Discussion Draft proposes linking rules (hybrid mismatch rules) that link the domestic tax treatment to the tax treatment in another country.

5. The rules are aimed at eliminating the mismatches arising from the existing tax systems, not questioning the appropriateness of differences in the tax treatment of

entities and financial instruments under the laws of individual countries. As such, they will apply comprehensively and automatically following the procedure.

6. When applying linking rules, no consideration will be given to such matters as where and to what degree base erosion took place and how tax revenue should be recovered. The primary purpose lies in eliminating the mismatches and thereby discouraging taxpayers from avoiding taxes.

7. We consider this approach, though theoretically clear, to be excessive as a measure of preventing limited abusive companies from avoiding tax. A particular concern is that, in many countries operating a self-assessment system for corporation tax, the taxpayers will have to ascertain the tax treatment of individual arrangements in other countries by themselves. We are concerned that such task may impose enormous administrative burdens and costs on taxpayers.

8. Taxpayers need to establish, *to the satisfaction of the tax administration*, that the deduction for the hybrid payment cannot be set-off against the income of any person under the laws of the other jurisdiction, in order to prevent stranded losses (italics added)(Page 51). Such requirement will also result in increased administrative burdens.

9. Another concern is that it will be up to each country to decide whether or not to incorporate hybrid mismatch rules into domestic law and, if deciding to do so, how to codify the rules into law. This means that if intergovernmental cooperation does not work, arrangements may be subjected to multiple tax systems and regulations, leading to the greater risk of double taxation. The mission the OECD is expected to accomplish in the field of international taxation is to eliminate double taxation. Close attention should be paid to ensure that too much focus on preventing double non-taxation will not result in increased double taxation.

10. The Public Discussion Draft proposes design principles for hybrid mismatch rules, such as avoiding double taxation through rule coordination, and being workable for taxpayers and keeping compliance costs to a minimum (paragraph 27). It is questionable, however, whether the proposals at this stage satisfy these principles. We request that the final report on BEPS Action 2 recommend measures more specifically targeting abusive arrangements. Linking rules should meet at least the following five conditions:

***Adopt a bottom-up approach***

11. As for hybrid financial instruments, a category of hybrid mismatch arrangements, the Public Discussion Draft proposes that no dividend exemption be granted to the payee if the payment is deductible by the payer.

12. Additionally, it is proposed that the scope of the hybrid financial instruments unconnected to a dividend exemption be stipulated by domestic law, using either a bottom-up or top-down approach (paragraph 116 and thereafter).

13. In this regard, we believe that the application of the bottom-up approach should be mandatory in light of the hybrid mismatch rules' primary purpose of preventing abusive arrangements and from the perspective of minimizing administrative burdens on taxpayers.

14. The top-down approach cannot possibly be accepted even if some carve-outs are permitted, because the approach encompasses all hybrid financial instruments including unintended ones. While some may argue that the bottom-up approach is not a comprehensive solution, we consider overly high compliance costs associated with the top-down approach to be far more problematic.

15. With regard to the denial of the dividend exemption, attention should be paid to the fact that, even if a payment is deductible by the payer, a deduction of the entire amount may not necessarily be allowed. This gives rise to a number of technical issues to be addressed concerning with what level of detail the denial of the dividend exemption should be made and in what way double taxation should be eliminated in the case of the dividend exemption being denied. This is same for other financial instruments.

***Develop a practicable definition of related parties***

16. The Public Discussion Draft states that, regardless of taking a bottom-up or top-down approach, hybrid mismatch rules should apply to financial instruments that are held by related parties or part of structured arrangements (paragraph 121). However, "a 10% or greater investment" proposed as the definition of related parties is broad.
17. In the first place, countries need to assess how serious the BEPS risk could be in the case of such a small shareholding. What we have to do is to specify abusive transactions that give rise to BPES and focus on eliminating them.

18. As the rationale for the 10% threshold, the Public Discussion Draft states that "companies, funds and other entities and arrangements can generally be expected to take into account the position of their non-portfolio investors (i.e. 10% or greater) when entering into their arrangements with those investors," and that "similarly any non-portfolio investor should, in general, have a sufficient economic stake in the issuer to obtain the information necessary to comply with the hybrid mismatch rule" (paragraph 127). Yet, it would not be easy for a taxpayer with only a 10% investment in another entity to ascertain the tax treatment in the country of the entity.

19. If an investee is a wholly owned subsidiary or other entity over which the taxpayer has strong control, the taxpayer might be able to communicate with the investee's finance department that has a wealth of knowledge about the country's tax laws. Otherwise, ascertaining the tax treatment in that country would require locating and hiring a local tax adviser, incurring substantial time and costs. On top of that, the country's tax authority might take a different view from that of the investee or the local tax adviser.

20. When specifying the definition of related parties in domestic law, each government will inevitably consider consistency with the existing domestic tax rules, such as those on dividend exemption, transfer pricing taxation and controlled foreign companies (CFCs). In the course of such process, whether or not the 10% threshold is appropriate will likely be discussed in each country. One of the design principles for hybrid mismatch rules is to minimize the disruption to existing domestic law. In accordance with this principle, careful discussions should be held on the definition of related parties, taking into account the circumstances of each country.

21. In the light of actual practices, we consider the appropriate definition of related parties of an entity to be consolidated subsidiaries for accounting purposes.

22. Whereas the Public Discussion Draft proposes a different scope for each category of hybrid mismatch arrangements, unnecessary complications of the system must be avoided. We believe that hybrid mismatch rules should apply only to arrangements entered into between related parties in all the categories including hybrid financial instruments, except for structured arrangements.

23. In connection with this point, hybrid mismatch rules should not apply to widely held instruments and traded instruments, such as listed or publicly offered products. We must avoid applying the rules in a way that discourages investors from investing in financial instruments.

24. The burden of ascertaining the tax treatment in another country should not be imposed solely on taxpayers; government should also be required to establish regulations on prior confirmation and ruling. We ask the OECD to publish the list of jurisdictions that have adopted hybrid mismatch rules and provide an outline of each of these jurisdictions' hybrid mismatch rules.

25. As for structured arrangements, it is imperative to specify requirements for the application of hybrid mismatch rules as suggested in paragraph 131, from the perspective of ensuring predictability for taxpayers.

***Take a flexible stance toward regulated industries***

26. Some financial institutions issue, for regulatory reasons, securities that may outwardly correspond to hybrid financial instruments. The uniform application of hybrid mismatch rules may therefore hinder the sound development of the financial industry.

27. For example, in capital-raising arrangements to comply with the minimum capital requirements under Basel III, some banks issue securities that are treated as subordinated bonds by the banks themselves but have the characteristics of preferred shares for final investors. Although those securities may correspond to hybrid financial instruments, it is not reasonable to apply hybrid mismatch rules to capital-raising schemes undertaken to meet regulatory requirements. Such securities issued for regulatory reasons should be treated flexibly, including exemption from the rules.

28. It can be said that the same problem may occur for industries other than in the financial sector, for example if a new regulation is introduced to those industries and companies have to observe them.

***Ensure consistency with other BEPS Actions***

29. BEPS Action 2 states that "this work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty

shopping." With regard to treaty shopping, the Public Discussion Draft on Action 6 has proposed a tie-breaker rule for determining the treaty residence of dual-resident persons (revision to Article 4, paragraph 3 of the OECD Model Tax Convention). Also, this Public Discussion Draft on Action 2 proposes the addition of paragraph 2 to Article 1 of the Model Tax Convention to ensure that fiscally transparent entities are not used to obtain the benefits of treaties unduly. However, as for CFC rules and interest expense deduction limitations, details of proposals have not been made public, partly because deadlines for Actions 3 and 4 are next year.

30. Hybrid mismatch rules, which are designed primarily to address deduction/no-inclusion structures, are closely linked to Action 4 for payer issues and to Action 3 for payee issues. In the BEPS Action Plan, too, Actions 2, 3, and 4 are under the same section entitled "Establishing international coherence of corporate income taxation." In view of these, it is more appropriate that Action 2 proposals and specific changes to domestic laws be examined after concrete proposals for all these Actions have been published. Coordination with Action 14 (Dispute resolution mechanism) is also indispensable so as to avoid double taxation. Countries should not hastily implement the recommendations under Action 2 alone.

***Reconsider the treatment of imported mismatches***

31. We find it unreasonable to stipulate that a taxpayer who is not a party to hybrid financial instruments, entity payments, and other arrangements be denied a deduction for the payment on the grounds that the counterparty's country does not apply hybrid mismatch rules. Such rule will undermine stable administration and result in increased uncertainty. Imported mismatches (paragraph 206 and thereafter) should not be subject to hybrid mismatch rules except when they arise from structured arrangements.

Sincerely,

Subcomittee on Taxation
KEIDANREN

To Achim Pross,
OECD's Centre for Tax Policy and Administration

Date May 2, 2014

From KPMG's Global International Tax Services Professionals

Ref OECD Hybrids Draft Comments.docx

cc Kate Ramm, OECD

John Peterson, OECD

Comments on OECD Draft Hybrid Mismatch Report

Professionals in KPMG's Global International Tax Services group welcome the opportunity to comment on the OECD's Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws) ("Hybrids Draft").

## I. Summary

KPMG recommends that the OECD:

a) Adopt the bottom-up approach to defining the scope of the hybrid instruments and transfers rules.

b) Increase the ownership threshold for related-party status to effective control. For this purpose, effective control could be defined as ownership of 50 percent of the voting power and value of an entity. If this recommendation is not followed, an exception should be provided for certain transactions between uncontrolled persons where those transactions bear market terms.

c) Provide separate rules for routine capital markets transactions entered into by collective investment entities as defined in the OECD Public Discussion Draft on The Granting of Treaty Benefits with Respect to Income of Collective Investment Vehicles ("CIVs").

d) Further clarify and refine the definition of a structured arrangement, particularly with respect to when a tax benefit is taken into account.

e) Exempt certain regulatory capital issuances from hybrid financial instrument status.

f) Increase intergovernmental cooperation to help member states determine "dual inclusion income" and the appropriate disallowance amount for purposes of the hybrid entity payment proposals.

g) Clarify that the rules for hybrid entity payments and reverse hybrid entity payments do not apply to deny a deduction to securitization vehicles.

h) Clarify that the proposed reporting requirements for intermediary companies with respect to imported mismatches and reverse hybrids is intended to be internationally standardized reporting consistent with the OECD's TRACE project and Standard for Automatic Exchange of Financial Account Information; and

i) Confirm that domestic law changes made pursuant to BEPS Action Item 2 should apply prospectively and provide for adequate transition.

We discuss these recommendations in turn below.

## II. Overview

The Hybrids Draft addresses three general categories of hybrid mismatch arrangements:

(a) Hybrid financial instruments (including transfers), involving deductible payments that do not give rise to taxable income in the payee's tax jurisdiction;

(b) Hybrid entity payments, involving deductible payments for which the tax benefit can be claimed in a second jurisdiction or which are disregarded in the payee's tax jurisdiction; and

(c) Reverse hybrid and imported mismatches, involving deductible payments made to an intermediary that are not taxable on receipt in the intermediary's or investor's jurisdiction.

For each of these categories, the Hybrids Draft recommends primary and secondary rules to eliminate the mismatch arising from the hybrid arrangement. If enacted, these rules would either deny the payor's otherwise available deduction for its payment, or force the payee to include in ordinary income an amount that would not otherwise be treated as income, with a priority mechanism to coordinate the two alternatives.

## III. Top Down vs. Bottom Up

The Hybrids Draft requests comments on the advantages and disadvantages of a "bottom-up" versus a "top-down" approach to define the scope of the hybrid financial instruments rule. The bottom-up approach would apply the rules when the parties are related or acting in concert, or participate in a structured arrangement. The top-down approach presumptively captures all hybrid financial instruments, but contemplates certain exceptions to the rules, e.g., for widely held or regularly traded instruments. Those exceptions would not apply, however, when the parties are related, acting in concert, or participating in a structured arrangement.

a. The bottom-up approach is less commercially disruptive

We believe that an important advantage of the bottom-up approach is that it would cause significantly less commercial disruption than a top-down approach, which may be expected to cause significant commercial disruptions to lending markets.

The top-down approach would include within the scope of the hybrid financial instrument rule many instruments that, as the Hybrids Draft notes, "present little risk from a hybrid mismatch perspective."[1] This approach effectively would require an analysis of <u>every</u> cross-border financing transaction. Recognizing this unlimited scope, the Hybrids Draft therefore provides for exclusionary rules that would remove certain instruments from the scope of the hybrid financial instrument rule. For example, the Hybrids Draft recommends that the hybrid financial instrument rule should not apply to "widely-held" or "regularly traded" instruments.

A widely held exclusion may not be available as a practical matter for many ordinary transactions in the capital markets. Such an exclusion would require both the issuer and the holders of the instrument to determine the ownership of the instrument and the proportion each owner holds. This requirement could cause significant hardship in lending markets, such as the United States, where such ownership is often held indirectly through custodians or other arrangements. Moreover, this ownership determination is likely to be required throughout the entire term an instrument is outstanding, would require detailed, potentially sensitive, information to be shared amongst unrelated parties, and would require ancillary rules governing the form, timing, and reliance upon such information. The compliance costs associated with the top-down approach could be substantial.

[1] Hybrids Draft, Paragraph 119.

By its terms a widely held instrument exclusion would not apply to repos and securities lending transactions that involve only a few parties. These types of transactions, however, provide critical short-term funding and liquidity in the markets. In these types of transactions, parties may not know who their counterparties are, much less whether the transaction gives rise to a mismatch. These transactions generally are priced at interest rates that do not take into account any tax mismatch – i.e., they are priced similarly to "straight" loans. A top-down approach thus could have a significant impact on this market, adversely affecting liquidity among financial institutions. Attempts to create exclusions from a top-down approach for these types of transactions also would create complexity.

Conversely, the methodology of the bottom-up approach could be applied without many of the commercial disruptions and costs noted above. The bottom-up approach would apply solely to instruments held between related parties (including persons acting in concert) and hybrid financial instruments entered into as part of a structured arrangement. Assuming the test for relatedness is reasonable (an issue discussed further below), then issuers and holders within scope could be expected to have on-hand or easily obtain the requisite information necessary to determine whether they fall within the scope of the hybrid financial instrument rule. Determining whether the issuer and holder are acting in concert and whether an instrument is entered into as part of a structured arrangement may cause some uncertainty, and therefore commercial disruption; however, such disruption and costs could be expected to be significantly lower than the disruptions and costs associated with applying the hybrid financing instrument rule broadly to all holders and issuers.

b. The bottom-up approach adequately addresses the types of hybrid financing instruments targeted by the hybrid financial instrument rule.

The Hybrids Draft suggests that an advantage of a top-down approach is that it would be more comprehensive. This may be true, but as countries develop expertise with the rules and identify types of transactions that should be included in the scope, the bottom-up approach would allow for additions to the types of transactions falling within its scope. Importantly, this process of adding types of transactions would be much easier and more efficient than removing transactions from a top-down approach if the rules cause problems in the market. This is because removing transactions from a top-down approach would require coordination among all countries, due to the hierarchy of rules, while adding transactions could be effective on a unilateral basis.

We note, also, that a top-down approach is no simpler for taxpayers or tax administrations (as is suggested in paragraphs 138 and 140 of the Domestic Law Draft), because all of the

concepts that need to be defined for a bottom-up approach (i.e., related parties, acting in concert, and structured transactions) would also have to be defined and applied in the top-down approach in applying any exception to the rule.

c. The bottom-up approach is more consistent with the design principles of the Hybrids Draft

The bottom-up approach also has the advantage of being more consistent with several of the design principles espoused in the Hybrids Draft, namely that the rules: (i) apply automatically; (ii) be clear and transparent in their operation; and (iii) be workable for taxpayers and keep compliance costs to a minimum.

For rules to apply automatically in practice, taxpayers must be able to determine whether the rules apply to a given transaction or arrangement. The bottom-up approach better enables taxpayers to make that determination, because under that approach the rules would be limited to situations in which the taxpayer knows or should know that the rule applies (assuming reasonable scope for the definition of related parties, acting in concert, and structured arrangement). By contrast, in an unrelated party context, taxpayers may not be able to obtain the information they need to determine whether a hybrid mismatch exists and whether an exception may apply. The same is true for the rules to be clear and transparent in their operation and to be workable for taxpayers – for these design principles to be met, the application of the rules must be clearly defined and must be limited to situations in which it is reasonable to assume that taxpayers have or can obtain the information necessary to determine whether the rule applies.

## IV. Related party threshold

The Hybrids Draft proposes that two persons be treated as related if one owns 10 percent or more of the voting rights or value of any equity interests of the other person. We believe that the appropriate threshold is one of effective control – that is, two persons should not be treated as related unless one controls the other or they are under common control. This standard is more consistent with the design principles articulated in the Hybrids Draft and would help ensure that taxpayers would be in a position to obtain the information necessary to apply the rule. The reality is that a 10-percent owner often will not be in a position to obtain the information necessary to determine the tax treatment of the counterparty, and thus whether the rules apply. In the case of indirect ownership, it often will be difficult even to determine whether the 10 percent ownership threshold is met.

While effective control could be determined based on a facts and circumstances test, in order to reduce compliance costs for taxpayers and enforcement burden for tax administrations it would be more appropriate and consistent with the design principles to apply a bright-line rule of 50 percent of the voting power and value.

Instruments entered into between issuers and holders with less than 50 percent ownership will often not be priced to reflect any tax mismatch, because neither the issuer nor the holder is in a position to control the other and, thus, the terms of the instrument. The acting in concert standard should fill in any gaps where this is not strictly true. Moreover, in the case of an instrument bearing market terms, a mismatch is likely unintentional and may not be apparent to the parties.

The definition of equity interests at paragraph 128 used to determine the ownership criteria for "related party" transactions is also very broad, and potentially includes a range of commonly occurring lending arrangements that are found in securitization and secured financing transactions. The definition includes "any interest in a person that includes an entitlement to profits". This definition potentially includes asset backed debt where the returns paid on the debt instrument to investors track the performance (including profits) of a pool of underlying assets held by the debt issuer. They might also include loans advanced under secured lending arrangements where the borrower's obligations to repay debt are limited to the cash flows from the assets funded by the debt.

These types of interests, however, do not provide the investor with any control over the securitization vehicle. The terms of these arrangements are designed to provide the investor/lender with an 'ownership' exposure to the underlying assets and not to the debt issuance vehicle, where the contracting party to the loan is the debt issuer. These common commercial lending arrangements should not be included in the definition of equity interests.

If governments determine not to raise the relatedness threshold more generally, these issues could be partially addressed through an exception for transactions in which: (i) neither party directly or indirectly owns 50 percent or more of the vote and value of the other, and no third person directly or indirectly owns 50 percent or more of both parties; and (ii) the transaction bears market terms. Further guidance would need to be provided as to when the terms of a transaction are market terms, but a starting point would be to determine a reference, non-hybrid transaction that has the same economic substance and compare that to the terms of the instrument in question. For example, in the case of a repo that is economically equivalent to a collateralized loan, the reference transaction would be a loan

for the same period, and the repo would bear market terms if it had an equivalent interest rate and other material terms.

## V. Routine Capital Markets Transactions by CIVs

Separate consideration should be given to whether routine financial transactions entered into by CIVs (i.e., funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established) give rise to the concerns raised in Hybrids Draft.

The profile and functions of CIVs suggest that the related party and acting in concert standards should not apply to CIVs. On the other hand, if a CIV were to enter into a structured transaction, then it should be subject to the recommendations of the Hybrids Draft.

Routine capital markets transactions entered into by a CIV could be inappropriately impacted by the Hybrids Draft recommendations with respect to hybrid financial instruments. With respect to the related party threshold, CIVs ordinarily would not be in a position to know the identity of investors behind intermediary distributors and could unknowingly become a related person to a counterparty, particularly including a counterparty that is an institutional investor. To protect their proprietary commercial relationships, intermediaries are generally unwilling to disclose the identities of their underlying customers to CIVs. This issue exists irrespective of the ownership threshold for a "related person" due to the lack of information available to a CIV about fund interests held through intermediary distribution channels and the CIV's inability to know whether it is related or not to any given counterparty.

The Hybrids Draft also provides that related parties include persons acting in concert, and that two persons will be treated as acting in concert in respect of ownership or control of any voting rights or equity interests if, among other things, the ownership or control of any such rights or interests are managed by the same person or group of persons. Under this standard, CIVs that have a common investment manager may be treated as acting in concert. We believe this is inappropriate in most cases. CIVs each have separate investment mandates and portfolio managers with fiduciary obligations to the investors in the CIV. Investment decisions for each CIV are assessed for that CIV by its portfolio manager in light of the CIV's investment mandate and what is in the best interest of the CIV's investors. Further, it is unclear how a requirement for CIVs to assess portfolio holdings of other CIVs in the same fund complex before entering into a financial

transaction could be implemented on a commercial basis or what benefit would be derived from doing so. And, where multiple CIVs were managed by the same portfolio manager, the portfolio manager would evaluate asset allocations for each CIV in a manner consistent with its fiduciary obligations to the investors in each CIV. Mere knowledge of holdings for multiple CIVs by a portfolio manager does not mean that those CIVs are being managed in concert.

If CIVs were not excluded from the related party or acting in concert standards, then an anti-abuse rule could be considered in order to address the unlikely situation where CIVs within a fund complex were actually acting in concert or situations in which CIVs should be treated as related to a counterparty to a financial transaction.

## VI. Structured Arrangements

Paragraph 131 of the Hybrids Draft sets forth a non-exclusive list of "indicators" that a particular arrangement was specifically structured to achieve a hybrid mismatch arrangement. Several of these indicators are objective and can be demonstrated through external evidence, such as offering materials, instrument terms, and/or a targeted issuance. Further guidance is needed, however, with respect to the factor based on whether the pricing of the arrangement took into account sharing of the tax benefit or the expected tax benefit of a hybrid mismatch. In some sense, every transaction's price takes into account the tax result to the parties, regardless of whether there is a hybrid element or not.

To further develop the pricing indicator, the OECD should adopt a safe harbor and/or set of guidelines for comparing the interest rate charged on (and other relevant terms for) a hybrid financial instrument with that of an otherwise comparable non-hybrid debt issuance. For example, a structured arrangement would not be presumed to exist unless the interest rate charged was at least [25 percent] lower for the hybrid alternative. This would exempt many market issuances for which the potential tax benefit is either not recognized by the parties or carries little or no weight in the investment decision, while appropriately focusing the structured arrangement definition on transactions for which the tax benefit can be objectively demonstrated to be a material factor for the payee.

## VII. Regulatory Capital

Paragraphs 158 to 162 of the Hybrids Draft recognize that there are scoping concerns in relation to hybrid regulatory capital. The use of hybrid instruments in a regulatory capital context has increased in recent years because of a desire by regulators to pass risk onto the

investor base – for example, contingent capital instruments have become more common because they allow for principal loss absorption. In many cases, these instruments will take the form of debt securities that have equity characteristics, and thus they might fall within the scope of the proposed rules on hybrid instruments. However, it is important to note that the equity-like features of the instruments are introduced at the behest of financial services regulators, who want to ensure that the debt is capable of loss absorption. This can be, for example, by way of (i) conversion to common shares as was the case in the February 2011 issue by Credit Suisse of US$2bn buffer capital notes or (ii) a principal write-down mechanism as was the case in the January 2011 issue by Rabobank of US$2bn perpetual non-cumulative capital securities.

Hybrid regulatory capital instruments, in particular additional tier 1 instruments, are increasingly common in the market and the classification of these instruments from a tax perspective is often difficult because the instruments invariably carry both debt and equity characteristics. Fundamentally, taxpayers seek certainty in how these instruments are taxed, not least because they form part of the structural capital of the organization – they are not introduced to arbitrage the tax treatment of the instruments between different jurisdictions; rather, they are introduced as a mechanism to share risk in a different way. It is acknowledged, however, that due to domestic policy choices there are differences in treatment of these instruments under existing law: some governments have given relief for payments under these instruments whilst others have not.

We believe that this situation should continue and that it would be undesirable for an OECD tax initiative to give rise to policy outcomes that may well be inconsistent with those desired by financial services regulators and governments. In particular, where countries have consulted extensively about the pre- and post-tax cost of the required increases in regulatory capital under Basel III and CRD IV and taken a conscious decision to allow a tax deduction for certain forms of regulatory capital to reduce the post-tax cost of certain categories of regulatory capital, it would be inappropriate for generic anti-hybrid measures to sweep in instruments which may be hybrids simply because they need to comply with regulatory capital requirements (e.g., requiring bail in) and where the hybrid aspects are not tax-driven. Different jurisdictions have adopted different approaches to dealing with the post-tax consequences of Basel III and CRD IV (with Spain, for example, implementing a new regime to turn certain tax losses into repayable credits so that these ceased to be deductible from Tier 1 capital). It is important that in jurisdictions which have chosen to introduce a specific regime to deal with regulatory capital banks should be able to issue new regulatory capital instruments (which are by definition long term instruments) with an adequate degree of certainty as to their tax treatment going forward.

We have set out in section III of this note our recommendations in relation to bottom-up versus top-down approaches to defining what should be within scope; in either case, we believe it is necessary that the proposals do not capture instruments that are issued as a result of regulatory capital requirements. Regulatory capital instruments have been introduced as a matter of public interest, and it would seem inappropriate to introduce rules that create commercial uncertainty in relation to those instruments. We recognise that, in due course, consultation should take place to ensure there are mechanisms to ensure that hybrid regulatory capital instruments are not being used to generate tax mismatches between jurisdictions.

## VIII. Dual Inclusion Income

In the context of the hybrid entity payments recommendations, the Hybrids Draft defines "dual inclusion income" as income that is "brought into account for tax purposes under the laws of both [relevant jurisdictions]." This definition can be applied in a straightforward manner where the potential items of dual inclusion income are recognized at the same time in each jurisdiction, or where the hybrid entity does not factually incur many different types of income. In many cases, however, the investor and entity-level jurisdictions will treat the hybrid entity as incurring income items in different years, or may include different income items in the tax base. The Hybrids Draft does not provide any guidance on how countries should reconcile these potential disparities.

Using the hybrid payment scenario from Figure 6, Paragraph 164 as a base case, assume that for Country A purposes B Co. generates 80 of income and incurs (100) of deductions, for a net loss of (20) that could be claimed by A Co. in Country A. For Country B purposes, however, B Co. generates 70 of income and incurs (80) of expense, for a net loss of (10) that could be shared with B Sub 1. What is the proper amount of the B Co. deductions that should be denied to A Co. under Country A law?[2] Potential answers include 10, the amount of the B Co. loss in Country B that could be shared with B Sub 1, 20, the amount of the net B Co. loss in the investor jurisdiction that would apply the primary rule, or even 30, the amount by which B Co.'s deductions for Country A purposes

[2] This hypothetical focuses upon the investor jurisdiction primary rule. If Country B applied the subsidiary jurisdiction secondary rule, the disallowance in this case should be the Country B loss of (10). This approach is most consistent with the recommendations' objectives and avoids the need to identify whether all the component income items comprising the 70 of income for Country B purposes are essentially the same as those comprising (70 of) the 80 of Country A income.

(100) exceed the amount of dual inclusion income apparently recognized by both Country A and Country B (70).

The Hybrids Draft suggests that Country A might decide to simply deny the (20) of loss that it recognizes.[3] This approach avoids the foregoing difficult questions and the administrative burden that would result from Country A's tax administrator trying to evaluate A Co.'s claimed treatment of B Co.'s income under Country B's tax laws. The Hybrids Draft also suggests, however, and we agree, that a more flexible and tailored approach targeting the amount of the loss that could be shared in Country B (10) is all that is necessary to deny A Co. and B Co. the benefit of the hybrid mismatch in the current year.[4] This would effectively limit the investor-level disallowance to the lesser of: (i) the loss included by A Co. for Country A tax purposes from its ownership of B Co., and (ii) the loss generated by B Co. for Country B tax purposes.

Such a rule could be applied by taxpayers, because the taxpayer would have to calculate the net loss under the laws of Country A and Country B in any event. On audit, however, such a rule would require the tax administration of Country A to understand the calculation of net loss under the laws of Country B in order to apply the rule. This could pose a challenge to tax administrations, but to some extent all of the proposed rules in the Hybrids Draft would require some understanding of the tax laws of the other relevant countries. These challenges could be mitigated by encouraging greater cooperation between tax authorities on cross-border audits, and we understand that the OECD and Forum on Tax Administration have ongoing initiatives to encourage that cooperation.

## IX. Application of Hybrid Entity Payments Rules and Reverse Hybrid Rules to Securitization Vehicles

The rules for hybrid entity payments that deny the deduction for the subsidiary and the reverse hybrids "defensive rule" that would deny the deduction of the issuer could pose significant difficulties for securitization vehicles. Investors in securitization transactions may hold their interests through layers of intermediary holding structures that are designed to pool smaller investors and streamline the management of the underlying debt cash flows.

[3] Paragraph 187, Hybrids Draft.

[44] To the extent Country A is concerned with timing differences regarding the other (10) that A Co. could deduct from its ownership of B Co., it might require a "recapture account" in future years if, for example, timing differences between Country A and Country B's tax laws reverse and B Co. in a future year shares a Country B loss with B Sub 1 that is greater than what Country A views A Co. as incurring from B Co.

Much like the position of CIVs, which is described at section V, securitization vehicles ordinarily are not in a position to know the identity of investors in instruments issued through intermediary distributors. The difficulties posed for securitization vehicles in establishing ownership will be particularly acute if the relatedness threshold is not increased as described above and the definition of equity interests is not revised.

As currently proposed, the measures could impose an obligation on a securitization vehicle to investigate the holding structure and the tax status of investors throughout the life of the vehicle. This is likely to place an undue burden of compliance on debt issuers which are open ended vehicles in which there are regular changes in the investor profile. In our experience, meeting this requirement may not be workable even in the case of a close ended structure because the relationship between investors holding different classes of debt instrument in the vehicle may not remain constant throughout the life of the vehicle.

We suggest that, with respect to securitization vehicles, these measures should be dealt with solely at the level of the investor jurisdiction and should not extend to the intermediary and debt issuer jurisdictions.

## X. Reporting Standards

The Hybrids Draft recommends that intermediary jurisdictions in the case of imported mismatches and reverse hybrids should impose appropriate tax filing and information reporting requirements on intermediaries to facilitate the ability of offshore investors and tax administrations to determine the income and gains derived by the intermediary and the amounts beneficially owned by each investor. In addition to clarifying what income is earned by what investors, this reporting could help clarify when, or in what proportion, payments made to an intermediary or CIV are denied deductions or treaty benefits in the source country because ultimately beneficially owned by an ineligible party.

It is not clear, however, what the intended scope of such a requirement would be, and the development of multiple different reporting standards would impose a significant and unnecessary cost on investors. The existing OECD TRACE project contemplates reporting by intermediaries, as does the Standard for Automatic Exchange of Financial Account Information. We assume that the reference to reporting in the Hybrids Draft was intended to refer to these projects, or at least to an internationally coordinated standard of reporting, and it would be helpful for the Hybrids Draft to clarify that.

## XI. Implementation Concerns

The Hybrids Draft does not discuss potential effective dates and/or transition periods for the recommended domestic law changes. We believe that proposals should apply only to payments made after the legislation has been implemented to avoid significant disruption to investments and investment flows. In addition, a significant transition period should be provided to prevent disruption of the markets.

Further guidance should also be provided as to how changes in domestic laws will be coordinated. Using the basic hybrid financial instrument from Paragraph 61 as an example, assume that in Year 1 Country B does not deny the deduction for B Co.'s payment to A Co. Applying the secondary rule, Country A forces A Co. to include the payment in ordinary income. The instrument between A Co. and B Co. is an ongoing arrangement that was entered into before Year 1 and continues after Year 1. If Country B subsequently adopts the proposed primary rule to deny B Co.'s deduction, we would assume that Country A should no longer require A Co. to include the payments in ordinary income.[5] That is, once Country B enacts and applies the primary rule to B Co. then there is no longer any need for Country A to apply the rule to A Co. The rules should be self-operating to facilitate this result, for example by marrying (non) application of the Country A secondary rule to the effective date for payments subject to the Country B primary rule.

[5] *See* Recommendation (b) on page 25 of the Hybrids Draft: "Jurisdictions should require a payee to include any payment made under a hybrid financial instrument as ordinary income to the extent that the payer is entitled to claim a deduction for such payment (or equivalent tax relief) and the payer's jurisdiction does not apply a hybrid mismatch rule in accordance with recommendation (a) above."

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FROM Mark van Casteren/Lucia Sahin - tax advisers
DATE 2 May 2014
RE Comments on Public Discussion Draft BEPS Action 2: Neutralise the effects of Hybrid mismatch arrangements

L.S.

Loyens & Loeff (**L&L**), an international law firm based in the Netherlands, Belgium and Luxembourg, has read your Public Discussion Draft on BEPS Action 2: Neutralise the effects of Hybrid mismatch arrangements (Recommendations for Domestic Laws) published on 19 March 2014 (the **Discussion Draft**), with great interest. Under the consultation process included in the Action Plan on Base Erosion and Profit Shifting (the **Action Plan**), all stakeholders are invited to send comments on the Discussion Draft to Working Party 11 of the OECD that has drafted the Discussion Draft. L&L welcomes this opportunity and is happy to provide you in this letter with a summary of its comments to the Discussion Draft.

## 1. General introduction and summary

The Discussion Draft is the result of work done in connection with Action 2 of the Action Plan. The Action Plan contains selected actions following the OECD report Addressing Base Erosion and Profit Shifting (the **BEPS Report**). Chapter 2 of the BEPS Report reproduces data on corporate tax receipts over time, provides an overview of statistics on foreign direct investments, and analyses relevant studies regarding the existence and magnitude of BEPS. It concludes that based on these data, it is difficult to reach solid conclusions about how much BEPS actually occurs. Chapter 2 of the BEPS Report concludes that most of the writing on the topic is inconclusive and the evidence that BEPS behaviours are widespread is circumstantial.

The recommendations to neutralise hybrid mismatch arrangements as included in the Discussion Draft are complex and radical. In our view, it will prove difficult to ensure that the combination of recommended changes to domestic law and the introduction of linking rules will meet the 9 design

principles as included in Chapter II of the Discussion Draft.

On the contrary, we believe that the implementation of the recommended rules:

- Cannot be considered to apply automatically, as in many cases it will be difficult to determine whether the rules apply at all and, if so, to what extent. On the one hand, this makes them unworkable for tax payers, substantially increasing compliance costs. On the other hand they will be difficult to administer for the tax authorities;
- May very well lead to double taxation, as it may not always be clear to what extent a payment actually was deductible (and at which level, current or deferred) and/or exempt (or deferred or taxable at a different level) and because of the place the proposed rules are said to take within domestic legislation, i.e. before any general non-transaction specific rules;
- May disrupt domestic law, as countries would need to fit the rules into their domestic system of qualification of financing and legal entities/partnerships etc. as well as their existing interest deduction limitations and rules for exempting income (based on legal provisions or case law).

## 2. Concerns with respect to the recommendations

### 2.1. Introduction

We describe some of our concerns with respect to the recommended rules in this letter. It has not been our intention to be exhaustive.

Our main concern is that implementing this type of legislation should be well considered by experts within the governments of the various countries involved as well as by business experts. We suggest giving priority to the design and implementation of sound rules over meeting an ambitious time frame. We recommend that the OECD will take sufficient time to give consideration to the comments received during the public consultation.

### 2.2. Recommended changes to domestic law and linking rules

Paragraph 52 of the Discussion Draft recommends changes to domestic law designed to reduce the incidence of hybrid mismatches and linking rules that specifically target the mismatch in tax outcomes under hybrid mismatch arrangements. In order to guard against the risk of double taxation, the recommended linking rules are divided into primary rules, which would apply whenever a hybrid mismatch arises, and secondary or defensive rules, which would only apply in circumstances where the primary rules do not apply in the jurisdiction of the counterparty. With respect to the category ‘hybrid financial instruments and transfers’, the primary rule provides that the payer’s jurisdiction denies the deduction. The secondary rule provides that the payee jurisdiction includes the payment as ordinary income. However, the Discussion Draft also recommends that all countries do not apply their dividend exemption to deductible payments (if they have an exemption system) and limit the foreign tax credits (if they have a credit system) for payments that are

deductible. The latter is described as a method to avoid hybrid mismatch arrangements, whereas the linking rules are meant to neutralize the effect of hybrid mismatch arrangements, once they occur.

We fail to see that the recommendation to deny the application of a dividend exemption to a deductible payment (thereby reducing the incidence of hybrid mismatches) is materially different from the secondary linking rule for hybrid financial instruments and transfers. In fact, the recommendation to amend a country's domestic law to deny a dividend exemption for deductible payments is a linking rule in itself, as the exemption of a certain payment would depend on whether such payment would be deductible in the counterparty jurisdiction. In order to meet the design principles (clear and transparent, workable for the tax payer), we suggest to delete the dividend exemption rule from the recommendations and to only recommend the implementation of the linking rules. The linking rules alone should suffice, though this would imply that the taxation rights of countries shift from the payee jurisdiction to the payer jurisdiction. If that is considered undesirable, it could be decided to switch the primary and secondary rule.

### 2.3. Deductions and ordinary income

The hybrid financial instrument rule should apply to any payment that is *deductible* under the laws of the payer's jurisdiction but not *included in ordinary income* of the holder's jurisdiction. Paragraphs 91 and further explain what is meant with the terms 'deductible' and 'included in ordinary income'. This explanation is very brief and does not address many issues that come to mind in this respect, such as how to deal with deductions and/or inclusion in income at another level within the group than at the level of the payer/payee. Many questions may come up on who should demonstrate that a certain payment is deductible and/or included in ordinary income. We expect that in practice it will be difficult to determine if, and to what extent a certain payment has led to a deduction and/or such payment was included in ordinary income. This would need further attention.

### 2.4. Effect of hybrid mismatch arrangements

Paragraph 99 describes that the linking rules for hybrid financial instruments and transfers are designed to limit the effect of the hybrid mismatch rule to mismatches that are the product of a hybrid element in the financial arrangement. The rules do not guarantee that the payment will result in an increased tax liability for the payer or the payee. Figure 4 shows an example of a hybrid payment that is made by a company in State B (**BCo**), to an exempt Charity, resident in State A (**Charity**). The example clarifies that under the recommended linking rules, a payment on a hybrid loan from BCo to Charity would not be deductible in State B, if it would also be exempt in State A in case it would have been received by a company that is normally subject to tax in State A. Thus, such a hybrid payment from BCo to Charity would not be deductible, notwithstanding the fact that any payments made by BCo to Charity are exempt with Charity. We do not believe that in such a case, it is reasonable or necessary that State B would deny the deduction for BCo. We also believe it will add unnecessary complexity that the tax authorities of State B would need to determine whether the payment made by BCo would have been exempt or not, if the payment was made to a

company that is normally subject to tax in State A, instead of Charity. This recommended rule would seem to violate some of the design principles (be workable for the tax payer/easy for the tax authorities to administer), apart from the fact that the outcome might be unreasonable. We therefore suggest to amend the rule in such a manner, that the qualification of the payment does not have any effect if it is exempt for another reason than its hybrid qualification.

### 2.5. Scope

The scope of the hybrid mismatch rules should be restricted in order to prevent unjust results and to make the rules workable for both tax payers and tax authorities. In particular, the 10% ownership threshold should be increased as such percentage of ownership does not guarantee that detailed information on the tax position of the related party will be available, nor does such ownership provide the influence required to amend the structuring of a financial instrument or hybrid entity. An unjust result would arise, for instance, if a 10%-investor triggers the application of the secondary rule for deductible hybrid payments. In such case the entire deduction would be denied at the subsidiary according to paragraph 189, while the subsidiary cannot exert any influence over its 10%-investor. This is an unreasonable outcome since this would result in double taxation for the other investors. We would recommend increasing the related party threshold from 10% to 33.33% (i.e. one third) ownership in the case of hybrid financial instruments and transfers and hybrid entity payments. A 33.33% threshold should better protect investors against situations of double taxation, since the entities involved in most cases will have the required influence and information available in order to avoid hybrid mismatches.

### 2.6. Co-ordination with other domestic rules

Paragraph 241 states that the linking rules should be applied before any general non-transaction specific rules (such as thin capitalisation rules) as they alter the specific tax effects of a particular transaction. We believe that the linking rules should be applied after all other domestic law rules that determine the taxable basis have been applied. This would minimize disruption to other domestic law rules and would also prevent the same payment from being prohibited from deduction and being forced to be included as income, which may occur under some domestic tax law systems and would result in double taxation. For example, if the primary rule is not applied to a disregarded hybrid entity payment, the deduction of the payment may still be denied pursuant to thin capitalisation rules in the payer's jurisdiction. However, since the primary rule was not applied in the payer's jurisdiction, the secondary rule would have to be applied in the payee's jurisdiction thus obliging the payee to include the payment as ordinary income. The result would be that the payment would not be deductible for the payer while the payee is taxed on the payment. Consequently economic double taxation would arise on the payment.

We trust our comments are of use in your further discussions and we remain at your disposal to address any questions you may have relating to the above.

Yours faithfully,
Loyens & Loeff N.V.

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From: Matthew Lykken[SMTP:MALYKKEN@GMAIL.COM]
Sent: Thursday, March 20, 2014 5:56:27 PM
To: Aggressive Tax Planning, CTP
Subject: Comment re: BEPS Action 2 - Recommendations for Domestic Laws section 190(c) Auto forwarded by a Rule

This comment pertains to BEPS ACTION 2:
NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS (Recommendations for Domestic Laws), section 190(c) "The primary rule also permits Country A to take steps to address stranded losses. These will arise when a duplicate deduction is denied in Country A but a corresponding deduction for a hybrid payment is not able to be set-off against income arising under the laws of Country B. Stranded losses could be addressed on a period by period basis (which would make the rule more difficult to apply) or could be addressed at the termination of the hybrid mismatch arrangement (e.g. on A Co's sale of its interest in B Co)."

By way of background, I am a retired international corporate tax attorney with nearly 30 years of experience. I currently have no personal interest in these matters, but I retain a citizen's interest in sound policy.

The ideal income tax system would allow a business to obtain a cash benefit for legitimate business losses equivalent to the cash detriment that the regime imposes on business income. In such a system, the government becomes simply a forced silent partner in the enterprise, and even a very high rate of taxation may then be tolerable. Thus, for example, if a tax regime provided an immediate 80% cash benefit for business expenditures and imposed an immediate 80% cash tax on business income, a would-be investor would treat a prospective business opportunity as if it was not taxed at all, but was only 1/5th the size of the gross investment. Thus, tax would be relatively unimportant in making the business investment go-no go decision. (Though decisions on the LOCATION of high-success-probability operations are different, and are highly rate sensitive.)

Tax regimes do not operate that way in practice, partly out of the pure desire to extract revenue, partly out of a desire to avoid subsidizing the misadventures of incompetent dreamers, and partly to minimize having to patrol abusive transactions in which sham investments are used to shelter other income. Still, it should be recognized that any significant deviation from this basic policy principle results in a tax regime that has a negative impact on legitimate economic activity and thus reduces overall public welfare.

The discussion draft seeks to follow the Dual Consolidated Loss model in restricting double deductions where there will not be a double inclusion of the related income. That makes sense, but the U.S. dual consolidated loss regime recognized (to some extent) that pure formula restrictions on the use of losses would be likely to violate the symmetry principle noted above, and that taxpayers should thus be permitted to elect to forego the deduction in one jurisdiction rather than risk losing it in both. Section 190(c) of the discussion draft contemplates restrictions that could leave a loss restricted indefinitely. Thus, if B Co. is a relatively minor profitable operation, the dual loss could be restricted despite the lack of any reasonable prospect of utilizing the majority of the loss. This may be true even if the choice of structuring was entirely legitimate, being designed to provide for a normal consolidated arrangement in the foreign location in the event that the investment succeeded.

The simple solution to this problem is to provide companies with a free election, which they may make with benefit of hindsight after the investment fails, to take the deduction in one jurisdiction

rather than the other. This may strike the drafters as over-generous to the extent that they contemplate a situation in which the investment funded by the debt was outside of the investor-country tax regime in a subsidiary under the foreign consolidation. That problem, however, is really a separate issue. If the investor country tax regime allows a company to borrow money, invest it in a subsidiary, and keep the interest deduction at home while pushing the related income outside of the tax net, that is an asymmetry that is independent of the hybrid double-deduction issue, and that should be addressed, if at all, as a discrete issue. So, one should separate out that question by considering the hybrid paradigm as one in which the debt and the investment are in the same entity, with that entity also being in foreign consolidation with a separate enterprise. In that scenario, the free election to take the deduction in either the investor's jurisdiction or in the foreign jurisdiction, whichever may be the most useful, in neither abusive nor over-generous.

Thank you for your consideration.

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# BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

This paper sets out our comments on the two Public Discussion Drafts published on 19 March 2014.

## General comments

1 The Discussion Draft recognises that it may be difficult or impossible to identify where tax is lost as a result of the presence of a hybrid instrument or hybrid entity, but appeals to the protection of the "collective tax base". Absent a larger international tax reform – such as a multilateral common corporate tax base, or formulary apportionment – there is no "collective tax base". Each state makes its own decisions on what to tax, and how to tax it.

2 As long as different sovereign states retain the ability to make their own choices about the classification of transactions, payments, instruments and entities for tax, legal, accounting, and other purposes, it is inevitable that some states will make decisions that are inconsistent with the decisions made by other states. In this context, it is unhelpful to refer pejoratively to arrangements that "exploit" the deliberate choices made by different jurisdictions.

3 For example, as a pragmatic measure to avoid arguments about entity classification between taxpayers and the tax authorities in the US, there is wide discretion to designate companies as transparent for US tax purposes by making "check-the box" elections (or, in reverse, partnerships and other entities can elect to be treated as opaque for US tax purposes). Similarly, in the Netherlands, a partnership will only be transparent for Dutch tax purposes if it is "gesloten" (closed: that is, no admission of new members without unanimous approval of the existing members) and will otherwise "openbare" (open) and so opaque for tax purposes. Neither approach affects the classification of an entity as transparent or opaque in other jurisdictions.

4 Cross-border mismatches due to hybrid instruments or entities are just one aspect of the differences in tax treatment that can arise in a cross-border situation. Any response limited to hybrids will not be "comprehensive". There is a risk of inconsistency if hybrids are singled out for counteraction, when similar differences due to variations in tax treatment or tax rates between jurisdictions remain unresolved. For example, deductible payments made by an entity in a high-tax jurisdiction to another entity in a low-tax jurisdiction (without a hybrid mismatch) can secure a lower overall tax burden in a similar manner to a hybrid mismatch.

5 Other BEPS actions will address similar issues: for example, Action 4 on base erosion from interest deductions and other financial payments, and Action 5 on harmful tax practices Any proposals arising from Action 2 must be coordinated with responses to the other Actions to ensure a consistent and coherent approach.

6 Any changes resulting from the proposals on hybrid mismatches could affect existing situations. We recommend that transitional provisions are included in the proposals: for example, grandfathering of existing position, to prevent unfairness to taxpayers who have complied with the law as it stands, but may find it difficult or disproportionately expensive to unwind or collapse that position.

## Specific comments

### Treaty issues

7 Understandably, as hybrid mismatches arise principally through the different choices made in the domestic tax rules in different jurisdictions, the paper on treaty issues is much shorter than the separate paper on domestic issues. We suggest that concerns about the potential abuse of double tax treaties should be addressed through BEPS Action 6, to avoid inconsistencies of approach between the groups considering different parts of the BEPS Action Plan.

8 In our view, the suggestion that a dual resident company should not be able to claim the benefit of a double tax treaty without a decision through the mutual agreement procedure is a recipe for uncertainty and delay, unless the mutual agreement procedures are also reformed to provide a clear and effective means to secure a binding decision within a reasonable time. Until then, the proposal carries a substantial risk of making tax treaties a dead letter for many taxpayers, and increasing the number of cases of double taxation, which will affect commercial situations not just cases of avoidance.

9 Domestic anti-abuse rules must have a part to play. As mentioned in paragraph 8, it must be right that a company that is treated as resident in a different jurisdiction under an applicable double tax treaty should not be treated as resident under domestic law.

10 We welcome clarificatory language on the application of double tax treaties to transparent entities, along the line suggested in paragraph 11.

### Design principles

11 Paragraph 27. We agree that tax rules should be clear and transparent, minimise distortion, be workable, and not entail undue compliance cost for the taxpayer or the tax authorities. We would add that tax rules should also be fair between different taxpayers, consistent, as simple as possible, neutral between different transactions, and encourage (or at least not discourage) economic activity and growth. This is the yardstick against which the BEPS proposals should be measured

12 Paragraph 55. There are particular issues with widely-held investment vehicles (such as collective investment schemes) and widely-held instruments (such as listed securities). Any proposals need to recognise that the vehicle or issuer may have no control over their counterparty and no access to information about them.

### Hybrid instruments

13 The proposed “linking” or priority rules in paragraph 81 are an ingenious device to connect deductibility of a payment in one jurisdiction with taxation of the payment elsewhere. However, an unanswered question is why one jurisdiction should take action to deny a deduction which otherwise meets all of its requirements to be deductible – for example, the payment meets an “arm’s length” transfer pricing test, is not caught by any general or targeted anti-avoidance rules, and is not denied a deduction for other tests (such as income or capital, or non-business purpose). If a payment to an entity in the same member state would be deductible, why should it become non-deductible because it is paid to an entity in a different member state, where the tax treatment happens to be different?

14 The hierarchy of linking rules also creates an element of uncertainty for taxpayers. Although the rules are meant to be automatic, the result will depend on the approach of the relevant tax authorities. (Will a payment be taxable in the recipient state? Or will a deduction be denied in the source state?) The position becomes even more difficult for “imported mismatches”, where the “defensive rule” may require a third country may be required to deny a deduction based on the tax treatment elsewhere.

15 Paragraph 88 indicates that timing differences are not important, but deferral regimes can mean payments that are (in principle) subject to tax are never in fact taxed. The proposals should also take account of taxation of the parent of a recipient of a payment under controlled foreign company regimes, not just taxation in the hands of the recipient.

16 Paragraph 90 suggests that simple accounting differences (the paragraph refers to difference between the valuation of amounts to be recognised) may be sufficient to trigger the hybrid mismatch regime, rather than mismatches between the tax rules.

17 In our view, the definition of a "hybrid financial instrument" should be "bottom-up" – that is, a specific list of characteristics within the scope of the rule – not "top-down" – that is, a general rule with a series of exceptions. Certainty for the taxpayer should not be sacrificed for comprehensiveness, and a "top-down" approach carries a significantly greater risk of unintended consequences. For example, it can't be the intention, as suggested in paragraph 152, that the hybrid rules could apply to any cross-border debt, without any hybrid characteristics, nor should lenders or borrowers be expected to include BEPS information provisions in their loan documents.

18 Paragraphs 158 to 162 discuss whether regulatory capital should be included in the scope of the hybrid mismatch rules. A wider question is whether the BEPS proposals were meant to affect the regulatory and commercial constraints on banks raising capital at all. We would suggest that they should be carved out entirely (or, rather, not included in the "bottom-up" approach we advocate above).

**Related parties and acting in concert**

19 Paragraph 125, 194. The proposed "bottom-up" rule would catch all instruments between related parties, including parties acting in concert. The proposed 10% test for parties to be considered "related" seems excessively low, and is likely to catch many portfolio investors with no significant influence over the arrangement. Investors may have, say, an interest of 11% or 12%, perhaps because another investor's interests have been cancelled or redeemed. A more appropriate test would be one of control – for example, over 50% of the voting rights, or over 50% of the economic interests – or at least one of a substantial connection, say no less a 25% interest.

20 Similarly, the test of "acting in concert" as catching any persons who act together "in respect of ownership or control" seems excessively broad. In our view, it should be limited to persons acting together to secure control of an entity.

21 Applying a list of indicia of a "structured arrangement", rather than clear rules, is likely to lead to uncertainty. Should an arrangement that is marketed fail, when the same arrangement (if not marketed) succeeds? The pricing of many transactions (from finance leases to the retail sale price of goods) takes account of the tax treatment. Is the incorporation of a new subsidiary or "special purpose vehicle" for a new transaction or a new business venture indicative of "tax-motivated structured products"?

**Hybrid payments**

22 The simplest approach to dual deductions would be to deny a deduction in one jurisdiction where a deduction is available in a second jurisdiction, but the proposed rules show the complexity that can arise when a taxpayer can be subject to tax in two jurisdictions. As a first step, further effort should be put into eliminating situations where a taxpayer is subject to tax in two jurisdictions (and conversely where deductions may be available in two jurisdictions).

**Imported mismatches**

23 The example in paragraph 198 illustrates a situation where a company is making a payment that would otherwise be deductible, and yet its deduction may be denied due to the tax planning arrangements of the recipient of the payment, possibly without the payer even being aware of those arrangements. In that sense, it is said that the mismatch between two jurisdictions (neither of which recognises the receipt) is "imported" into a third jurisdiction, where a deduction is allowed.

24 We repeat our comment above: in this situation, where the borrowing costs would otherwise be deductible for the payer, it is not clear whose tax base is being eroded. The paying jurisdiction allows a proper cost, the intermediate jurisdiction properly applies its rules so the arrangement is neutral, and the final jurisdiction properly applies its rules in deciding that the payment is outside its tax charge.

25 If there is an objectionable element in this scenario, it is that no country recognises the receipt, and that is where the remedy should lie. As is suggested in paragraph 219, the primary rule should be tax in the investor jurisdiction (through CFC rules or otherwise), or alternatively tax in the intermediary jurisdiction. In our view, the "defensive rule" of denying a deduction in the payer's jurisdiction is disproportionate and unfair.

**Macfarlanes LLP**
2 May 2014

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2 May 2014

Dear Sirs,

**BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements**

We refer to the Public discussion draft *BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements* published on 19 March 2014, on which public comments are expected by 2 May 2014.

It is with particular pleasure that we would like to bring to your attention our observations, comments and possible suggestions to the above-mentioned draft (the "**Consultation Document**").

## General remark on the scope of the Consultation Document

Considering that Action Plan 2 is aimed at developing a comprehensive approach to the hybrid mismatch, we think that it could be considered if the recommendations should expressly mention also net wealth taxes (and other indirect taxes having a similar nature) and make it clear that defensive rules aimed at neutralizing hybrid mismatches should address also situations where a taxpayer may benefit from a deduction of a certain liability from the net wealth tax base which corresponds to the non-inclusion of the related asset in the taxable base of its counterparty.

## IV. Hybrid Financial Instruments & Transfers

### Questions 1 & 2

1. Considering the complexity of the scope of the Action Plan 2, we are generally of the view that the principles and the linking rules contained in this Consultation Document are clear and comprehensive.

2. We understand that in order to neutralise the effect of mismatches that can arise under hybrid financial instruments the Consultation Document recommends that, in the cases where the domestic rules do not provide for a general rule excluding dividend exemption for deductible payments, the primary response should be given by the State of the payer by denying a deduction for payments made under a hybrid financial instrument. The State of the recipient will apply a secondary or defensive rule that would require a deductible payment to be included in the income in the event the payer was located in a jurisdiction that did not apply the primary rule, thus enabling deduction even in presence of a mismatch.

3. In our opinion, in order to enhance simplification and align tax outcomes in the States of the payer and in the States of the recipient, the best approach would be to have the primary action taken by the State of the recipient in all events (and not only when there is a general rule excluding dividend exemption for deductible payments) for the following reasons.

> 3.1 First, relying on the State of the payer (such State preventing the deduction of the payment) would concentrate on such State the administrative burden of ascertaining on which payments the deduction should be denied in case the payment is made to several recipients in several States some of which only provide for exemption on the incoming payment. The adoption of an inverted approach where the primary rule would be the inclusion of the payment as income (if it is deductible in the other State) would also eliminate the substantial need to isolate and carve out cases like widely-held or regularly traded instruments (as indicated in Paragraph 146 *et seq.* of the Consultation Document).
>
> 3.2 Secondly, exemption methods laid down by most domestic rules, supranational rules (like the EU Directives) and Article 23A of the OECD MC rely on the rationale of eliminating double taxation, a goal which is frustrated by the deduction in the State of the payer. So, action by the recipient State would more smoothly eliminate a frustration of such exemption rules. In the EU context, this would also be in line with the proposal to amend the European Parent-Subsidiary Directive mentioned in Paragraph 14 of the Consultation Document.

**Question 3**

4. The exclusion of deemed payments (only for tax purposes) from the definition of the term "payment" under the hybrid mismatch arrangements covered by the Consultation Document as indicated at Paragraph 21 thereof is generally shared by us; indeed, if in a State a deduction is allowed only for tax purposes, there is not a real mismatch because the other State will not recognise any corresponding exemption or exclusion until the moment when a real "payment" (as defined in Paragraph 21) occurs. However, given the variety of the instruments and arrangements at stake, it could be appropriate to specify that, wherever deemed payments made under the instruments may give rise to D/NI outcomes (such as some of the examples indicated at Paragraph 64 of the Consultation Document), these should also be caught by the rules.

5. Action 2 is aimed at neutralising the effects of hybrid mismatch arrangements that can be used to achieve unintended double non-taxation, double deduction "*long-term tax deferrals*". On that basis, in our opinion, Paragraph 26 and 88 of the Consultation Document seem to be not consistent with the aim of Action 2 since it is specified that the hybrid mismatch rule limiting D/NI outcomes should not address differences in the timing of payments.

**Question 4**

6. The explanation of the two approaches to drafting the scoping rules is very extensive and clear. In general terms, we believe that a top-down approach would be preferable as it would be more comprehensive and effective, would ensure the absence of any discriminatory effect and would result to be simpler from a tax compliance and tax administration perspective. Certainly, as indicated in the Consultation Document, the top-down approach could present some compliance concerns and information requirements, as well as risks of manipulation (especially if policy reasons lead to exclude the cases of ordinary lending arrangements between unrelated parties and widely-held and traded instruments), but it cannot be ignored that also the bottom-up approach could imply a degree of subjectivity in the identification of "structured arrangements", which might lead to a similar risk of manipulation and impose similar compliance concerns.

**Question 5**

7. Among the difficulties that may arise in the application of the rules neutralizing hybrid mismatch instruments, we believe the following elements should be taken into account.

7.1 First, it is not clear whether the concept of "deduction" and "deductible" payments mentioned at paragraphs 92 and 93 should be interpreted as referring to the effective or only to a theoretical deduction of the payment from the income of the payer. For instance, a payer could find itself in the position of not deducting a payment – which is in principle deductible under the domestic laws of the State of the payer – for a number of reasons (including the choice not to deduct); in this event, it is not clear whether the payment (in theory deductible but in practice not deducted) would be regarded as "deductible" or not for the purposes of the rule. Under a substantial approach, we think it would be appropriate to specify that a payment falls into the category of "deductible" items only in the cases in which such payment is effectively taken into account in the calculation of the taxpayer's net income so that it practically leads to a mismatch.

7.2 Second, we think that it would be useful to provide more detailed recommendations to the States on how to define the evidence that a taxpayer has to provide to demonstrate either the non-deduction of the payments in the State of the payer or the inclusion of such payments in the ordinary income under the domestic law of the State of recipient. In this respect, we would welcome a higher degree of detail of the type of evidence that should be provided.

**V. Hybrid Entity Payments**

**Question 1**

8. We welcome with particular interest the results of the OECD debate on hybrid entity payment mismatches included in the Consultation Document.

9. We are generally of the view that the overall approach adopted by the Consultation Document is clear and comprehensive. Nonetheless, in order to facilitate the understanding of the hybrid taxpayer "*offset[ing] the deductible payment against income that is not dual inclusion income*" (Paragraph 184) we would suggest to clarify in Figure 6, 7 , 8, 9 and 10 of the Consultation Document that the term "non-dual inclusion" income identifies the income of

the non-hybrid entity to which the deduction is surrendered (B Sub 1).

10. Similarly, in order to ensure a better understanding of the application of the Primary and Secondary rules in different DD and D/NI scenario, we would suggest that some more detailed guide and numeric examples be added to the Consultation Document (as it has been done in Paragraph 71 and 82).

11. Inasmuch D/NI scenarios are concerned, for the same reasons pointed out at paragraph 3. above, we would recommend the adoption of an inverted approach, whereby the primary response is taken by the payee jurisdiction, which will therefore include the hybrid payment in its taxable income.

12. Finally, we note that in the first sentence of Paragraph 180 the word "non" has been seemingly omitted. Such sentence should read as follows: "*As noted in the discussion above, hybrid payments that trigger duplicate deductions only raise base erosion and profit shifting issues when the deduction is permanently set-off against income which is not subject to tax in both jurisdictions (i.e.* ***non****-dual inclusion income)"*.

**Question 2**

13. In our opinion the outcome of rules' operation is clearly defined.

14. As far as we understand, the rules addressing dual resident companies would apply either insofar the procedure set forth under Paragraph 3 of Article 4 of the Model Tax Convention, as proposed to be replaced by the OECD Public Discussion Draft "*BEPS Action 6: preventing the granting of treaty benefits in inappropriate circumstances*", does not come to a mutual agreement or in cases where no tax treaty is in force between the two States. On this subject, we refer to our comments dated 9 April 2014 on Public discussion draft "*BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances published on 14 March 2014*".

**Question 3**

15. In line with our comments at paragraph 4. and 5. above we deem it useful (i) to include deemed payments in the definition of (disregarded) "hybrid payments" wherever such payments may

give rise to D/NI outcomes; (ii) to reconsider the treatment of mere differences in the timing of payments in the D/NI outcomes.

**Question 4 and 5**

16. Preliminarily, we would recommend to clarify that Paragraph 195-196 need to be read consistently with Paragraph 122, which relates to hybrid financial instruments. Therefore, the hybrid entity payments rule should cover all mismatches that arise between related parties regardless of whether the hybrid entity interest is "widely held".

17. As regards the definition of related party, we draw the attention to Paragraph 127, whereby it is stated that "*non-portfolio investors [i.e. 10% or greater] should, in general, have sufficient economic stake in the issuer to obtain the information necessary to comply with the hybrid mismatch rule*". We believe that in many cases the 10% threshold may be not sufficient for this purpose. On the other hand, such threshold may somehow induce investors to contractually agree that such an entity will fulfill any information request before acquiring an interest in it.

18. As pointed out at paragraph 7.2 above, we would welcome more detailed recommendations to the States on the evidence to be provided by a taxpayer in order to demonstrate that the deduction for the hybrid payment cannot be set-off against the income of any person under the law of the subsidiary jurisdiction (Primary rule) or of the investor jurisdiction (Secondary rule).

**VI) Imported mismatches and reverse hybrids**

**Question 1**

19. Comments: none

**Question 2**

20. We think that the elements needed to be present in order for the defensive rule neutralizing reverse hybrids and imported mismatches to apply are clearly defined. In particular, we share the comment laid down in Paragraph 218 whereby the simplest and most direct way of avoiding the effects of imported mismatches is for all countries to adopt the same set of hybrid mismatch rules.

21. However, in our view the recommendation to target Reverse Hybrids by broadening the scope of application of CFC or other

similar anti-deferral regimes should be reconsidered, also in the light of the general statement contained in paragraph 26 that pure deferral should not be caught by the rule (but please consider our comment in paragraph 5. Above).

22. The D/NI outcome of Reverse Hybrids arises indeed at the time of the payment by the intermediary to the investor, whilst the application of CFC rule would imply the taxation in the hands of the investor of payments made by the payer to the intermediary.

23. In addition, a comprehensive and automatic application of such rules to Reverse Hybrids, regardless of whether the parties to the mismatch are members of the same group or the structure represents an avoidance arrangement, may represent an infringement of fundamental freedoms under the EC Treaty. According to the case law of the European Court of Justice, the restriction to the freedom of establishment deriving from CFC rules may indeed be justified only by the need to prevent tax avoidance or abuse that is limited to wholly artificial arrangements so that its application should be excluded if the taxpayer demonstrates that the transaction serves bona fide business purposes (see, amongst others, Decision of the European Court of Justice C-196/04 of 12 September 2006, Cadbury Schweppes; Communication from the Commission of the European Union to the Council, the European Parliament and the European Economic and Social Committee, The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries, COM(2007) 785 final).

24. On this basis, the D/NI outcome of a Reverse Hybrid does not by itself justify the application of CFC rules but should in our view be rather prevented by excluding dividend exemption in the investor jurisdiction to the extent it is a payment made by a subsidiary that is treated as transparent under the laws of the State where it is established and operates.

**Question 3**

25. Based on our understanding, the defensive rule recommended in relation to imported mismatches and reverse hybrids implies the denial of the deduction in the payer jurisdiction if the taxpayer (i.e., the payer) is party to an avoidance arrangement.

26. In this respect, in order to define cases where the payer may be regarded as party to an avoidance arrangement, the relevant anti-abuse provision should in our view be drafted so as to deny the deduction if the imported mismatch arrangement originating the D/NI outcome represents an artificial arrangement. It would not instead in our view be appropriate to refer explicitly or implicitly to the subjective intentions of the payer, whose assessment may lead to a great deal of uncertainty.

27. In determining whether an arrangement is artificial a useful guideline may be inferred from Art. 13, Paragraph 4, of the proposed Council Directive implementing enhanced cooperation in the area of financial transaction tax (COM(2013) 71, Final of 14 February 2013), whereby an arrangement is regarded as artificial in case it involves one or more of the following situations:

a) the legal characterization of the individual steps which an arrangement consists of is inconsistent with the legal substance of the arrangement as a whole;

b) the arrangement or series of arrangements is carried out in a manner which would ordinarily not be employed in what is expected to be a reasonable business conduct;

c) the arrangement or series of arrangements includes elements which have the effect of offsetting or cancelling each other;

d) transactions concluded are circular in nature;

e) the arrangement or series of arrangements results in a significant tax benefit but this is not reflected in the business risks undertaken by the taxpayer or its cash flows.

Yours sincerely,

Maisto e Associati

Mouvement
des Entreprises de France
MEDEF

Pascal Saint Amans
Director
OECD Centre for Tax Policy and Administration

CC: Raffaele Russo
Achim Poss

May 2nd, 2014

# Comments on BEPS Action 2: Neutralise the effects of hybrids mismatch arrangements

Dear Pascal,

MEDEF is pleased to provide comments on the two Discussion Drafts "Neutralise the effects of hybrids mismatch arrangements" issued on 19th March 2014 (hereafter "the draft(s)").

MEDEF supports the objective of tackling artificial hybrids mismatches arrangements: this will help creating a level playing field for stakeholders.

However, we are concerned by the absence of delineation between intended and non-intended non-taxation: it is not useless to recall that the Action Plan is targeting abuse and artificial situations creating base erosion and profit shifting. The OECD should focus on intentional or abusive use of the situation.

First, mismatches can be unintentional as they result from the coexistence of at least two different tax regimes. The OECD should focus on situations where the mismatches are intentional: the instrument is designed for benefiting from a mismatch or the arrangement is structured for benefiting from a mismatch.
Second, the OECD should focus on situations where the mismatch are intentional and have no economic grounds except to benefit from a tax advantage (i.e., tax driven hybrids).

From a business perspective and contrary to the statement of §28, it is necessary to distinguish between what is acceptable and what is not.

**Domestic laws draft**

1. We are concerned by the fact that the draft focuses on deduction/no inclusion or double deduction situations without considering (i) the intent of Governments when allocating their tax regimes, (ii) the fact that the transaction/structuration at stake may be fully compliant with tax laws and (iii) the absence/presence of intention from the taxpayer. In our view, this makes the proposed solutions not consistent with the design principles mentioned in the draft at paragraph 27.

   - (i) The draft does not take into account the intent of Governments when designing their tax regimes. Indeed, preventing States to apply their tax policy when voluntarily granting a preferential regime will interfere with their tax sovereignty and discourage tax competition. Sovereign States shall retain the power to design their tax system according to their priorities, economic needs and competitiveness. This includes the possibility to create incentives and regimes offering favourable treatments for certain activities or operations.

     In this respect, the objective of **minimising "disruption to existing domestic law**" as a design principle seems difficult to achieve. If a country voluntarily decides not to tax an income, this should not automatically allow the other country to tax or not to deduct the expense at stake at its level.

     Besides, we wonder whether it is EU compatible since the proposal will most probably affect the freedom of establishment and the free movement of capital whereas the ECJ requires a safeguard clause. Indeed, this might lead to a differentiated treatment according to whether the transaction is purely domestic or not.
     Moreover, the fact that the jurisdiction **shall not need to "establish that it has lost tax revenue**" seems not in line with BEPS objective -and more specifically with the necessity of base erosion- in the first place.

   - (ii) Business is expected to take advantage of incentives explicitly provided by tax codes as part of its cost-efficiency strategy. Taking the least costly legal option offered by

Governments cannot per se be condemned or quoted as abusive. This will lead to great uncertainty and will impose a burdensome reassessment by genuine business of their cross-border transactions.

Due to the very broad scope of a hybrid arrangement (different characterisation of a payment under the laws of different jurisdiction) all internal and external in- and out-flows of a taxpayer are likely to qualify as a hybrid as long as it has not checked the tax treatment of its counterpart. Since the burden of proof relies on the taxpayer, the proposed approach is all but **workable** for businesses.

· (iii) The draft also states that domestic law should eliminate the mismatches without distinction between intended and unintended ones. It means that there is neither purpose nor intention test. This position relies on the assumption sets up in §4 according to which current anti–avoidance rules are note adapted to tackle non taxation through hybrid mismatch arrangement which is debatable. This will create a situation where genuine and artificial businesses are treated the same way, without considering the intent but solely taking into account the result.

In this respect, the principle of **automaticity** is very debatable in the BEPS context as not only abuse will be targeted but also every transaction, without considering the economic grounds. It will create some compliance costs and uncertainty for genuine businesses which may by far exceed abusive situations.

2. We are very concerned by the complexity required by the implementation due to the absence of harmonisation notably in the financial ambit (debt vs equity) and advocate for a more targeted solution.

We understand the difficulty to find a harmonised solution as countries are free to define the scope and to which extent an item is included in the income. Besides, considering the variety of tax regimes, it seems particularly difficult to impose a "one fits to all" option. Still, it is the responsibility of Governments to dismantle the unwanted hybrid mismatches through either domestic law which contributed to their creation or tax treaties

The recommendations based on the denying of deduction or inclusion of tax revenue (§58) through broad and complex interrelated rules remain problematic:

- it implies for businesses to know how the income has been treated in the State of residence of the counterpart (burden of proof, transparency of other countries' tax regime…);
- it might also be highly uneasy to control by tax authorities in an acceptable legal framework;
- it could lead to **double taxation** whereas the transaction is not abusive:
  ex:

- A loss might be deductible a certain year but subject to a claw back several years latter (tracking very difficult);
- Conversely an expense might not be deductible a specific year but become deductible in the future;
- Triangular situations could be very difficult to follow (e.g. deduction in A and non-taxation in B but taxation in C via CFC);
- An expense might be deductible but never be deducted in practice because of a change of ownership jeopardizing the loss carry forward.

In this respect, for hybrid instruments, a possible solution might be for States to agree in their tax treaties on a harmonised definition of debt and equity. Such a solution would solve the situation where mismatch due to different characterisation for the same payment leads to leads to double taxation.

Moreover, we consider that (i) rules concerning hybrids should only apply to related parties situations (the affiliation threshold for the definition of related parties should be increased to at least 25%) and tax-motivated structured arrangements; (ii) the "bottoms-up" approach should be preferred; (iii) the proposed rules should include a safeguard clause so that taxpayers may demonstrate that the instrument or arrangement is not tax driven; (iv) WHT should be taken into account and exclude the application of an anti-hybrid rule.

**Treaty draft**

This draft recommends adding a specific anti-abuse provision in the OECD Model tax convention.

If our understanding is correct, the situation of dual/ transparent entities is already treated in BEPS action 6: more information of the articulation between those two actions would be welcome.

Concerning the place of management (§7): "*case by case*": will not solve the situation especially as the criteria are the same plus "*any relevant factor*" which is arbitrary.

Concerning the use of credit method (§ 18/20): If the aim of the OECD is to favour the credit method, some developments are required in order to address situations where double taxation is not eliminated (e.g. tax treaties should explicitly provide for the possibility to carry forward the use of the tax credit which might not be used the year during which the related income has been included in the taxpayer tax basis due to insufficient tax).

We are particularly concerned by the proposed rule to deny participation exemption in respect of dividend which has given rise to a deduction (§84 of domestic report and § 20 of treaty report) regardless of the situation. It will require switching from an exemption system to a credit method which is a very burdensome system (see recent experiences where countries have abandoned this method as it is difficult to manage in practice: States like the UK and Canada have opted out and

others like the USA are discussing this matter). The USA may be able to cope with it due to the "check the box" election and the possibility not to repatriate too much income; this is less the case for European Groups that have higher dividend pay-out. We believe that Controlled Foreign Companies ("CFC") rules should be sufficient to tackle this kind of base erosion.

We also believe §16 "*Any jurisdiction that grants an exemption for dividends under domestic law should deny the benefit of such exemption if such dividends are deductible in the payer State*" might create double taxation situations:

Ex: Country A considers dividends as deductible interest. It is not subject to domestic corporate tax but to a withholding tax ("WHT") when crossing the border. Country B receives the dividends and is legally entitled to apply the participation-exemption regime. According to the draft's recommendations, it is not possible to apply the regime: dividends received will be subject to taxation and it will not be possible to offset the WHT (different qualification).

We hope our contribution will give you a clearer insight into our expectations. We remain at your disposal to interact on any of the above issues and will also be pleased to answer any questions you may have regarding these comments.

We would be particularly interested into providing oral comments during the public consultation on the discrepancy we feel between the design principles and the proposed solutions.

Yours sincerely,

Vanessa de Saint-Blanquat

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May 1, 2014

Organisation for Economic Cooperation and Development
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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.

## 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

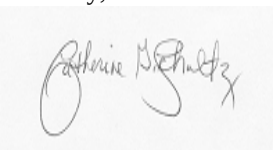
The Discussion Draft proposes a system of primary, secondary, and defensive rules to address imported mismatches and reverse hybrids. These rules seem unduly complex and should be reconsidered.

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.

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.

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.

ORGANIZATION *for* INTERNATIONAL INVESTMENT
Global Investment Grows America's Economy

May 2, 2014

Organization for Economic Cooperation and Development
International Co-operation and Tax Administration Division
*aggressivetaxplanning@oecd.org*

Mr. Achim Pross
Head, International Co-operation and Tax Administration (OECD/CTPA)
OECD, 2, rue Andre Pascal
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France

**Re: Organization for International Investment (OFII) Comment Letter on the OECD Discussion Draft on BEPS Action 2: Neutralize the Effects of Hybrid Mismatch Arrangements**

Dear Mr. Pross,

The Organization for International Investment (OFII) is a not-for-profit U.S. business association that represents the U.S. subsidiaries of global companies headquartered outside the United States. On behalf of its member companies, OFII promotes policies that enable global companies to establish U.S. business operations. As such, we advocate for fair, non-discriminatory treatment of businesses engaged in inbound U.S. investment. In particular, OFII's members support economic and tax policies that facilitate cross-border trade and investment.

Based on our more than two decades long history of promoting U.S. inbound investment from global companies, we are keenly aware of the complex issues raised by the OECD's Discussion Draft on BEPS Action 2 (Discussion Draft). OFII appreciates the efforts made by the OECD in putting together guidance in this difficult area. Hybrid instruments and entities are a natural consequence of the interaction of each country's domestic rules and, as a result, are common in cross-border commerce, independent of tax motivations. OFII supports carefully crafted rules that prevent abuse of hybrid arrangements while ensuring that legitimate business activities and transactions carried out in the ordinary course of business are not impacted.

OFII agrees with the approach of the design principles that hybrid mismatch rules should be consistent, clear, targeted in their approach, administrable, avoid double taxation, and minimize disruption to domestic law. The Discussion Draft states that "the hybrid mismatch rules should not generally interfere with hybrid entities or instruments that produce outcomes that do not raise tax policy concerns."[1] However, we are concerned that certain recommendations in the Discussion Draft would be at cross purposes with those stated goals, penalizing enterprises engaging in legitimate business transactions, resulting in double taxation and inhibiting cross-border investment.

[1] Paragraph 26 of the Discussion Draft on BEPS Action 2.

Accordingly, as discussed in detail below, OFII believes the OECD recommendations should be limited to tax-motivated hybridity and avoid creating an environment that results in double taxation. Failing to do so will create uncertainty for taxpayers and tax administrators and will impede cross-border commerce.

The following discussion provides detailed comments expanding on OFII's concerns with the Discussion Draft.

***The OECD Recommendations Should Avoid Double Taxation***

Avoiding double taxation should be a guiding principle of the BEPS recommendations. In particular, the design principle of avoiding double taxation should not be limited by the phrase "through rule coordination." Rather, the BEPS recommendations should be crafted and targeted towards the broad, fundamental principle of not creating double taxation.

Income inclusions under anti-deferral regimes should be taken into account. The two key mismatch arrangements identified in the Discussion Draft are payments that are deductible under the rules of the jurisdiction of the payor and not included in income of the recipient (the so called "D/NI" outcomes) and payments that give rise to duplicate deductions from the same expenditure (the so called double deduction or "DD" outcome). We appreciate that the Discussion Draft recognizes that domestic rules should be coordinated with controlled foreign company ("CFC") regimes to the extent that a CFC regime would create a deemed income inclusion and does so in the context of reverse hybrids and imported mismatches. The Discussion Draft recognizes the complexity of coordinating CFC rules with D/NI arrangements arising from hybrid financial instruments and hybrid payments and therefore does not take into account CFC income inclusions in its proposals regarding hybrid financial instruments and hybrid payments. We recognize a primary rule taking into account CFC income inclusions would be difficult. However, failing to do so would result in double taxation. *To address both complexity and avoid double taxation, we recommend that taxpayers should be able to defend against application of the primary rule (i.e., a denied deduction) by establishing that the income is subject to inclusion under an anti-deferral regime.*

Income subject to withholding should be excluded from D/NI Arrangements. Payments that are subject to a withholding tax do not raise the same policy concern expressed by the OECD because such payments are subject to tax. If a deduction is denied in the payor's jurisdiction and the payor's jurisdiction has collected a withholding tax, the payment is effectively taxed twice. Excluding payments that are subject to a withholding tax from D/NI arrangements reduces the risk of double taxation, creates a greater level of certainty for taxpayers, eases the administrative burden on the tax administrator, and would not impede on cross-border investments. *The recipient of a payment that is subject to a withholding tax should be treated as being taxed on ordinary income and, accordingly, should not be in a "no inclusion" category of income.*

Capital gain inclusions should be treated like any other income inclusion. Although a country may have a capital gain regime, the rate of tax may actually be the same as ordinary income, as is the

case in the United States for corporate taxpayers. In fact, in the United States capital gains are taxed less favorably than ordinary income because capital gains are ring-fenced and cannot be offset by ordinary deductions. Denying a deduction for a payment that is subject to capital gain taxation will routinely result in double taxation. *Payments taxed under a capital gain regime rather than an ordinary income regime should be excluded from a "no inclusion" category of income.*

More targeted double deduction rules are needed to avoid double taxation. As currently drafted, the double deduction rule seeks to neutralize the effect of duplicative deductions by denying the deduction of the payment in the investor's jurisdiction to the extent it exceeds the claimant's "dual inclusion income" (the primary position) or to deny the deduction for the payment in the subsidiary jurisdiction against non-dual inclusion income (the secondary position). Dual inclusion income is defined as income that has been subjected to tax as ordinary income in both jurisdictions. We acknowledge the proposed approach would *prima, facie,* result in neutralizing a mismatch in the form of a current double deduction. However, permanently disallowing the deduction rather than deferring the deduction until the hybrid entity has net positive income creates double taxation. We note that timing differences are taken into account in the Discussion Draft when determining D/NI outcomes. This prevents a deductible payment that is not taken into account currently from triggering D/NI sanctions as long as the income is taken into account over time. The DCL rules generally provide that, a disallowed loss (*i.e.,* a loss that is potentially deductible in two jurisdictions) is permitted to be carried forward and utilized when the hybrid entity has net positive income. This avoids potential double taxation that would otherwise arise when the entity has net losses in one year and net income in other years. Such an approach would target the perceived abuse (*i.e.,* one economic loss which is being used to offset two different income streams) and would limit the potential for double taxation. *We recommend an approach similar to the United States dual consolidated loss rules (the "DCL rules"). Additionally, we recommend that timing differences should be taken into account in determining D/D outcomes.*

***The OECD Recommendations Should Be More Targeted To Abusive Tax Practices***

As recognized in the Discussion Draft, hybridity is the natural consequence of the intersection of the laws of two or more jurisdictions. The Discussion Draft acknowledges the "design principles should be targeted to arrangements that engineer mismatches that raise genuine policy issues."[2] However, as currently drafted, the hybrid mismatch rules would apply to transactions designed to either capture the economics of the transaction or are required to be structured a certain way for legal, accounting, or political reasons. This approach would disrupt legitimate cross-border trade and investment.

The "bottom-up" approach should be applied to the hybrid financial instruments rule. *We urge that the OECD adopt a bottom-up approach rather than a top-down approach*. OFII is concerned that a top-down approach would introduce significant administrative burden for taxpayers and administrators, particularly if information needs to be obtained from unrelated parties. A bottom-up approach would target transactions that raise genuine policy concerns and were engineered to shift

[2] Paragraph 42 of the Discussion Draft on BEPS Action 2.

profits offshore, while avoiding unnecessary uncertainty and administrative burdens for taxpayers and administrators.

Imported mismatches are best addressed in the other Action Steps. *We believe that adopting a comprehensive hybrid rule in the imported mismatch proposal is undesirable and can be more effectively addressed in a bilateral fashion*. Of particular concern is the difficulty in achieving workable coordination of the imported mismatch rules on a multi-jurisdictional basis. The need for a rule applicable when the recipient of a payment is an intermediary to ensure the proposed rules are not sidestepped is understood. However, formulating a single recommended rule that properly recognizes or produces an appropriate result across the wide variety of relevant domestic tax laws will be unworkably vague and risks significant double taxation. If a recipient's country has rules that allow included income to escape taxation, such a result should be addressed in the harmful tax practices project or be addressed by the individual jurisdiction. We believe the recommendations in regard to Action 6 on treaty abuse go a long way in addressing imported mismatches, both in terms of the considerations countries should take into account before entering into a tax treaty and in the inclusion of an anti-treaty shopping provision in treaties that, for example, includes a treaty resident meeting a base erosion test in appropriate cases.

BEPS Action 2 should be coordinated with other BEPS Action items
*In addition to the above, we recommend that the work on BEPS Action 2 is coordinated with the other BEPS Action items on CFC, interest deductibility, and harmful tax practices.* The recommended hybrid rules consist of multiple layers and may differ per category of hybrid mismatch. This complexity adds to the administrative burden and increases the risk of double taxation. A coordinated approach with other BEPS Action items, both in terms of content and timing with respect to the entry into force of the rules, ensures proper interaction between the overall recommendations whilst balancing the impact of the rules across jurisdictions.

Ordinary course of business payments should be beyond the scope of the hybrid rules. *In order to minimize the disruption to cross-border trade and commerce, OFII recommends that arm's-length deductible payments incurred in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank be excluded from the definition of deductible payment*. This approach would be consistent with the base erosion test included in the limitation on benefits article in the Discussion Draft of Action 6. It is also common in the limitation on benefits article of most U.S. income tax treaties. The payor of an ordinary business expense should not bear the burden of proving how the payment was treated in the recipient's jurisdiction nor penalized to the extent the payment is either not included in ordinary income or treated as a hybrid payment in the recipient's jurisdiction.

A threshold test should apply before deductions are disallowed. *Disruption to cross-border trade could further be minimized by providing a threshold before the hybrid mismatch rules apply*. For example, in a related party context, if the tax benefit from the hybrid arrangement exceeded 50 percent of the payor's adjusted taxable income, the deduction could be deferred until the payor had

enough income to support the deduction. This type of approach, which is consistent with the earnings stripping rules in the United States, would not only cause the least amount of disruption to global commerce, but it would ease the compliance burden for the taxpayer and reduce the complexity for tax administrators.

The scope of the Discussion Draft should be restricted to transactions that involve hybridity. *OFII believes any transaction that does not involve hybridity should be outside of the Discussion Draft*. That is, BEPS Action 2 should be balanced with the remaining BEPS Action projects. For example, transactions that involve permanent establishments, CFC rules, or potential treaty abuse, should all be addressed in their respective working groups. In particular, the examples at paragraphs 167 and 257 do not involve hybrid instruments, hybrid payments, reverse hybrids, or imported mismatches and should be addressed in other BEPS Action Plans.

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OFII appreciates the opportunity to provide comments on the OECD BEPS Action 2 Discussion Draft. We hope that the OECD takes into consideration the fact that countries have started to unilaterally adopt positions that are inconsistent with the Discussion Draft. While we realize that the OECD has acknowledged that "unilateral measures could lead to global chaos marked by massive re-emergence of double taxation,"[3] individual countries and the European Commission have nevertheless started to adopt their own local rules to address the hybridity concerns addressed in the Discussion Draft. We recommend that the OECD propose remedial measures in order to reduce the burden of double taxation on taxpayers where countries address hybridity in an inconsistent manner.

We hope the above comments will prove helpful in further refining the Discussion Draft. We look forward to the prospect of commenting on further developments under the OECD BEPS Action Plan.

Sincerely,

Nancy McLernon
President & CEO
Organization for International Investment

[3] OECD (2013) *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing at 10.

**Enclosure**

***Comments to BEPS ACTION 2: neutralise the effects of hybrid mismatch arrangements***

*Written by:*
W.R. Munting
J. van der Wal
W.J. Otterspeer

**Box 1.:**

Q 1. Are the objectives and design principles of the hma's clear?

Response: no.

Q 2. Where is further qualification required and how could it best be provided?

Response and recommendations:

We believe that hybrid mismatch arrangements (hereinafter: hma's) should only be countered for tax purposes if they are abusive in the sense that they serve no other purpose than to avoid taxation in one of the member states involved. In practice, however, an hma is more often a disparity than a deliberate tax avoidance scheme. One good example is the "quasi tear 1 capital instrument". These instruments, introduced by and for banks and financial institutions, can be described as a form of note issue on a stock exchange with hybrid conditions comparable with the hybrid conditions mentioned in this BEPS ACTION 2. They have been developed to ensure that banks or other financial parties fulfill the minimum core capital equity requirements introduced by the authorities. The instrument is also called *"quasi tier 1 capital"*, because it is materially most akin to equity but is legally still qualified as a loan. The instrument is likely to be considered an hma, although it is clear that a quasi tier 1 hybrid instrument is not intentionally set up for tax reasons and that, considering the open character of the instrument, it is very difficult to verify whether mismatch tax consequences exist.

Furthermore, we believe that abusive hma's should only be scrutinized in and by the country who suffers from the tax avoidance by means of a tax revenue decrease. In our experience this is normally the source (activity based) country, rather than the resident (shareholder's) country. If the source country chooses to allow a deduction for payments on an hmi, regardless of the tax treatment in the residence country of the investor, this should be assumed a conscious decision by the source country based on its national sovereign tax policy. Requiring the residence country of the investor to tax payments on an hmi in such cases would violate the generally and internationally accepted, fundamental principle of

territoriality: it is the source country where the funds are used to finance the activities which generate taxable profit, and it should be the source country to decide whether or not to tax (or whether or not to allow a deduction). Requiring the residency country of the investor to tax may very well mean conferring a right to tax to a country where there is little to no substance and little to no activity that would justify taxation in that country.

The problem of double non-taxation potentially caused by hma's can only by solved through harmonization and/or coordination of domestic(tax) rules if this takes place globally. Otherwise, abusive hma's will find their way to non-participating countries.

We firmly believe that imposing adjustments to national law is not the solution, the solution should be found in bilateral- or multilateral tax treaty negotiations, resulting in adequate enforcement of the arm's length principle and exchange of information.

We believe that countries already have a broad range of tools at their disposal enabling them to levy and collect their fair share of taxes:

**1. Transfer Pricing rules**

- If debtors in an hma pay a non arm's length interest amount, tax authorities of the debtor's Country may refuse deductibility of interest to the extent that the interest payment is not at arm' s length;
- The debtor's country may even argue to wholly or partially requalify a debt as equity if the debt materially equals equity
- Other hma's (e.g. use of hybrid entities) may be countered through arguing that the hybrid entity in the residence country can not be considered economic owner of the asset due to a lack of substance and control; such hybrid entity may then be disregarded by the source country.

**2. Permanent Establishment (pe) profit allocation rules**

Recently the OECD has introduced the new rules (as mentioned in Art. 7 of the OECD model-treaty) regarding allocation of income to pe's, the so-called Authorized OECD Approach (hereinafter: AOA). The AOA rules determine that the allocation of profit to a pe should be (more) in line with the allocation of profit to entities. Therefore, there should be an analytic (compare with TP functional analysis) approach which uses the functions performed, assets used and risks assumed as a base. This approach should enable a country on which territory activities are performed (territorial principle of taxation) to tax its fair share, i.e. by arguing that the hybrid entity may have a pe on its territory and that the AOA-rules apply.

**3. Transparency rules**

At several occasions (OECD harmful tax competition/EU Code of Conduct) countries have agreed that tax (and other) rules and tax (and other) information should be shared freely and

spontaneously between treaty partners. Therefore, OECD member states should have enough knowledge of each others tax systems and tax rules to take their well balanced decision on how to treat foreign hma's in their domestic (tax) law.

## 4. Exchange of information

In order to be able to tax their fair share in a globalised economy, where taxpayers have the possibility to allocate income in territories where information is undisclosed, it is clear that an efficient system of exchange of information is crucial for tax administrations around the world. Today almost all countries in the world have embraced this exchange of information. Especially as far as corporate income tax is concerned. Therefore, tax authorities should, with the instruments already available, be able to have or obtain all the necessary information to also levy their fair share.

These are fair rules laid down in formal and informal bilateral and multilateral tax treaties and (to a large extent) based on OECD models, which should be fairly enough for both source countries and residence countries to levy their fair share of tax.

Finally, if hma's are to be banned, we wonder why are notional interest deduction schemes allowed? This distorts the level playing field between countries who stimulate their economies through hybrid instruments (e.g. Brazil/Australia) and countries who stimulate their economies through (deemed) interest deduction on equity (e.g. Belgium).

## Box 2. Questions for Consolation

1. Is it clear what elements need to be present in order for the rules neutralizing hybrid financial instruments (hfi's) or hybrid transfers to apply?

No, the rule order is very unclear: E.g. Par. II.17 more or less defines a mismatch as a mismatch. This is not really explanatory language. We would be interested to learn what, according to the OECD, is the international definition of a hybrid instrument.

Primary and defensive rules:
1. "jurisdictions should deny a deduction for any payment made under a hybrid financial instrument" (primary rule) and
2. "A dividend exemption should not be granted" (defensive rule).

If these rules would be applied independent of one another (which could be the case, in practice), it would result in double taxation. The defensive rule is unnecessary if the primary rule is applied. But if the source country does not apply the primary rule, it should be considered the source country's intended decision, the residence country should not interfere.

The commentary says that the focus of the rule is on the mismatch and not on the country who suffers the loss of tax revenue caused by the mismatch. However, to us it seems that the arm's length allocation of income principles should be decisive. The hma rules contravene the much more fundamental arm's length principle.

4 (a)

What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration?

Both approaches lead to uncertainty for taxpayers because tax authorities can choose whichever approach deemed necessary to counter hfi's: if the other country allows interest deduction, they tax the corresponding income; if the other Country does not allow a deduction, they are allowed to tax also (classical tax systems). Therefore, the basic rule to counter hfi's should simply be exchange of information (current system) based upon which both countries can decide what to do. But is should be within the control, responsibility and authority of the source country and not of the other country, because the decision of (non) deductibility is a unilateral one and not a bilateral one. Only if the decision leads to double taxation the countries may choose to enter into a mutual agreement procedure (MAP).

5 (a)

It is very difficult to qualify financial instruments in advance. By doing so the commercial investment climate (funding of investments) for companies might be influenced negatively.

6 (b)

Debt issuers, Merchant bankers and other parties involved in the financial market may find it very difficult to qualify financial instruments as being "safe" or not. To protect investors and issuers from severe tax consequences, even more comprehensive studying than is currently the case, would be necessary to qualify the instrument accordingly. This leads to unnecessary delay on the financial markets and causes potential lack of economic growth.

5 (c)

Yes, we refer to (b)

7

The fundamental rule should be: exchange of information (please compare with EU Savings directive)

8

See our comments under Box 2 regarding quasi tier 1 instrument.

**Box 3.**

1. Is it clear what elements need to be present in order for the rules neutralizing deductible hybrid entity (dhe) payments to apply?

Yes.

2. Is the outcome of the rule operation clear?

No. When does the stranded losses rule apply? Is the taxpayer required to convince the tax inspector of country A that he was not able to use all losses in country B? What if both countries use different methods for determining the tax base? These rules should be clarified in much more detail. Again the solution is should be: if country A and country B are well informed about the facts, they may curb the mismatch or not, as long as they are in a position to do so. It should be up to the authority's own choice to implement such rule or not.

Box 4 and 5 (Reverse hybrids)

We refer to our comments on hma's, which also apply to reverse hybrids.

Comment BEPS Action 2 (**treaty issues**)

Paragraph 20/22

It seems that the new article favors the credit method as the applied method to prevent double taxation rather than the exemption method. We think that both methods at least should be of the same ranking. It is up to the treaty (and therefore also the model treaty) to allocate income and it is - after allocation - up to the country who has been granted allocation to tax or not to tax. It is not for the Country who gives up taxing rights to interfere with the receiving Country's system of taxation. Vice versa, it is not for the receiving Country to interfere with the system of the granting Country, as long as double taxation is prevented.

**Conclusion**

*Our key comment is that the fundamental solution to abusive hma's should be found in consistent and correct application of the at arm's length principle as set out in the OECD Model Convention, and the OECD's own transfer pricing guidelines, in conjunction with the application of the OECD's exchange of information standard. In the presence of adequate exchange of information, the arm's length principle provides tax administrations all the necessary instruments to correct undesirable tax consequences of hma's. If, in spite of exchange of information and the at arm's length principle, the source country chooses to allow a deduction for payments on an hmi, this should be assumed a conscious decision by the source country based on its national sovereign tax policy. Requiring the residence country of the investor to tax payments on an hmi in such cases would violate the generally*

*and internationally accepted, fundamental principle of territoriality. In other words, the OECD has already provided for the full array of measures to adequately counter abusive hma's. It is up to the member states to make full and appropriate use of these measures.*

# *PwC's comments on Action 2*

## 1. Introduction

1.1. PwC welcomes the opportunity to comment on the OECD Public Discussion Drafts regarding BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws; the 'Discussion Draft') and (Treaty Issues; the 'Treaty Discussion Draft'). As a global professional services business with a network of firms throughout the world, we have worked with many tax authorities over many years on the evolution of anti-abuse rules that affect cross-border finance and investment flows. As a result, we have extensive experience with the wide range of existing local legislation and the challenges it poses for both taxpayers and tax authorities. The response in the pages that follow reflects the views of the PwC network of firms.

1.2. We acknowledge that 'hybrid mismatches' can be responsible for double non-taxation and base erosion that are the targets of the G 20 heads of government and the OECD. We welcome the Discussion Draft's careful exploration of a global solution where national rules are linked by the common implementation of domestic anti-hybrid rules to prevent double non-taxation occurring in the differences between national systems.

1.3. As reflected by the length of the Discussion Draft addressing domestic legislation, the subject matter is extremely complex. By its nature, this topic is interlinked with other key elements of the BEPS project, including the recommendations on CFC rules (Action 3), interest deductions (Action 4), harmful tax practices (Action 5), treaty benefits (Action 6), and transfer pricing outcomes (Actions 8-10).

1.4. We recognize the size and difficulty of the task being addressed by the Working Group on Action 2. We commend the Discussion Draft for addressing, in a comprehensive manner, many aspects of hybridity. However, the complex nature of the subject matter, and the inherent challenges in designing recommendations, are such that we do have some concerns which are reflected by our comments highlighting a number of areas in which we believe further consideration of the impact should be undertaken.

1.5. These concerns around the interlinking of this Discussion Draft and the overall complexity of the proposals are the key drivers in our recommendations below.

## 2. Our recommendations

2.1. In order to address the concerns set out above and in the remainder of this document we urge consideration of the following recommendations:

2.1.1. Even under the narrower-scope "bottom up" approach, the proposed rules would apply to all related-party instances. However, there are many related-party arrangements where there is no abuse. As such, the proposed recommendations would have disproportionate consequences and could negatively impact on global trade and investment in an unforeseen manner. We therefore suggest that a purpose or motive test is included, without regard to the other recommendations below, to cover all instances

2.1.2. We also urge that sufficient time be dedicated to allow for modifications to the design of the recommendations. These modifications would ensure that the recommendations with regard to hybrid mismatches are focused only on abusive outcomes, do not result in outcomes which give rise to double taxation, and are coordinated with the work of the other key working groups on CFC, interest deductibility, treaty abuse, and harmful tax practices.

2.1.3. If a delay in publishing the final report on hybrids beyond the scheduled September 2014 date is considered unacceptable, then we strongly urge that the report adopt an interim solution, pending the outcome of the other relevant workstreams. This interim solution should include a purpose or motive test.

2.1.4. The final recommendations under Action 2 should make it clear that, in any event, countries are urged not to unilaterally enact legislation on hybrid outcomes until conclusions have been reached on the other key interlinked workstreams and consensus is reached on a final set of uniform principles to be applied.

2.2. The objective of seeking a coordinated, consensus response across multiple jurisdictions is, we believe, the primary objective. In our view, the complexity of the issues and interactions set out in the Discussion Draft, both at a policy level and with regard to the detailed mechanics of the recommendations, could result in an outcome whereby jurisdictions are not able to universally adopt some or all of the recommendations in a coordinated, consensus manner.

## 3. Policy issues

3.1. Whilst there are a number of detailed comments with regard to the Discussion Draft which are addressed below in this letter, there are several high-level considerations which we suggest need to be addressed in the finalization of the Action 2 recommendations.

3.2. The approach taken by the Discussion Draft is heavily influenced by two key policy decisions. The first is that any hybrid mismatch resulting in lower aggregate tax -- whether intended or unintended -- gives rise to an

inappropriate result. The second is that it is not necessary to determine whether the recommended rule negates the hybrid mismatch in a manner which is consistent with the perceived tax advantage being achieved in each specific jurisdiction.

3.3. Governments set their tax policy having regard to a number of factors including, *inter alia*, the legal framework operating in the jurisdiction and the need to encourage economic activity and investment (including the balance of whether the jurisdiction is capital exporting or importing), as well as the political agenda of the government in question. Given that different governments will see the balance of these factors from a different perspective, it is natural that mismatches will arise in the treatment of cross-border payments. Even at the most basic level, the widely differing tax rates that exist amongst the G 20 members will, by definition, give rise to cross-border investment decisions which, to some degree, will be driven by the tax rate differentials that exist.

3.4. Allied to the differences in tax rates, countries will introduce both incentives and disincentives within their tax systems to encourage certain types of behaviour. Recent examples of such incentives include, *inter alia*, regimes to encourage research and development, regimes to encourage the relocation of intellectual property or manufacturing, and other investment incentives.

3.5. In addition, a number of jurisdictions have introduced regimes challenging tax outcomes which are deemed inappropriate from that jurisdiction's perspective, many of which address some or all of the hybrid mismatches described in the Discussion Draft. These regimes have been designed to prevent the tax outcome in question in a manner consistent with the relevant fiscal policy of the jurisdiction in question, having regard to all of the factors outlined above.

3.6. In this context, drafting a series of recommendations that are based on an assumption that all hybrid mismatch outcomes are inappropriate is disproportionate. There exists a risk that such broadly drafted recommendations, if enacted, could result in significant unforeseen negative consequences on global finance and trade which could impact global economic growth. It is for this reason that we strongly suggest that the Action 2 workstream revisits the policy decision that all hybrid mismatch outcomes resulting in lower aggregate tax should be negated and reconsiders the decision to draft the recommendations with no motive or purpose test. We acknowledge that this approach may require additional tax administration resources and introduces some level of subjectivity, but the downside risk of unforeseen consequences

merits such an approach.

3.7. The second key policy decision, not limiting recommendations so that the appropriate jurisdiction adjusts the tax outcome, leads to potential results which might be regarded, from an overall policy perspective, as being as inappropriate as the hybrid outcomes that the Discussion Draft is seeking to address.

3.8. The design of the recommendations is such that, in many cases, a source jurisdiction will be required to deny a deduction to a specific taxpayer whilst an equivalent deduction will be allowed to another taxpayer. This difference in treatment may well arise solely as a result of a tax outcome in another jurisdiction, potentially not even a direct party to the cross border transaction.

3.9. To force a denial of a deduction in a source jurisdiction in this manner is overly comprehensive and gives rise to inconsistency that may result in jurisdictions choosing, in the interests of their overall fiscal policy, not to implement such wide-ranging recommendations, leading to potential dislocation of the international tax system. Such situations should be addressed by ensuring that there is a coherent set of rules dealing with CFC regimes, the application of tax treaties, and harmful tax competition.

3.10. It seems more appropriate for source jurisdictions to ensure they are appropriately protected from BEPS with robust interest deductibility rules, rather than applying hybrid mismatch rules in a manner where the denial of deduction is not the appropriate response to the hybrid mismatch arrangement. For the investor jurisdictions, a robust CFC (or similar) regime, as required to meet those jurisdictions' fiscal policy, would provide the necessary protection in a more coherent fashion. It is for this reason that we strongly suggest that the Action 2 Working Group revisits the policy decisions that (a) the jurisdiction of the 'inappropriate' impact of the hybrid mismatch outcome be disregarded and (b) that the recommendations be drafted with no motive or purpose test, as well as also ensuring that the Action 2 recommendations be more closely aligned and timed with the other relevant working groups.

3.11. A further high level issue which should be addressed is the potential economic impact of the proposed recommendations, if adopted. It was acknowledged in the Addressing Base Erosion and Profit Shifting Report released in 2013, that data showing the actual impact of BEPS on global tax revenues and FID was inconclusive. Action 11, which will seek to provide further data, is not scheduled for release until September 2015. We strongly suggest that an economic analysis be carried out to ascertain the potential impact of the recommendations in the Discussion Draft to ensure that their impact is not disproportionate and thus

give rise to an unforeseen barrier to global trade, investment and economic growth.

## 4. **Purpose Test**

4.1. As noted above, PwC regrets that a subjective purpose or motive test is absent in these Action 2 proposals. Objective mechanical tests such as those recommended in the proposals may offer certainty, but such tests do not take into account situations that are not abusive but happen to fall within the defined parameters. If the OECD seeks to ensure that global commerce operates without distortion resulting from income tax considerations, then such unintended applications of mechanical tests would be counter-productive.

4.2. A structured purpose test would reduce the likelihood of unintended consequences and limit the collateral damage that could arise if the implementation of these proposals affects innocent parties or gives rise to double taxation. A structured purpose test would provide a subjective test of a taxpayer's motive, that is, whether the intent of a particular hybrid entity, instrument or structured transaction is tax avoidance. Such a test would require a consistent standard, such as 'principal intent' or 'substantial purpose,' which could be applied to all situations. In order to ensure consistency, a structured purpose test should also include certain presumptions based on specified hallmarks of potential abuse.

4.3. A purpose test seems particularly important in the context of transactions between unrelated parties, where the potential for abuse is generally much lower. Such unrelated transactions that might trigger application of mechanical hybrid mismatch rules should be subject to a purpose test in order to ensure that mechanical rules not be applied inappropriately to transactions that lack the requisite tax avoidance motive.

4.4. Even in a related-party context, a structured purpose test would be essential in ensuring that routine intercompany transactions reflecting normal business practices not be penalized simply because a hybrid transfer or entity happens to be involved. Alternatively, rules implementing the Action 2 proposals could include a 'business purpose' exception for related-party transactions, where the taxpayer has the burden of proof to show that such transactions have no tax avoidance motive.

4.5. We acknowledge that the introduction of a structured motive or business purpose test will likely increase the burden on tax administrations. Furthermore, we acknowledge that, to provide the certainty for taxpayers and tax administrations alike, this may result in the need for a ruling process in many jurisdictions. Nevertheless, we suggest that governments should ensure that tax administrations be adequately resourced to allow this to happen, so as to avoid the economic damage that could be done by the alternative of broadly

drafted rules applying in non-abusive situations.

## 5. **Design Principles**

5.1. Certain elements need to be added to the Action 2 proposals in order to establish an appropriate balance between double non-taxation, double taxation and the need of states to secure economic growth. If the proposals do not establish such a balance, there is a significant risk that certain jurisdictions will not implement the proposed hybrid rules, and the resulting playing field will not be level.

5.2. It is our view that under the proposal, in conjunction with other Action Points, there is significant risk that the focus will tend towards double non-taxation, at the expense of double taxation, which will, inevitably, lead to a negative economic impact.

5.3. Design principles that are most likely to be under pressure in practice are the following:

5.3.1. **d** (avoid double taxation through rule coordination). Although the OECD seeks to promote multilateral application of consistent principles, there is a significant risk that jurisdictions may enact rules based on the Action 2 recommendations that do not dovetail with the way in which other jurisdictions implement these recommendations or, indeed, that jurisdictions do not adopt the recommendations at all. We believe strongly that any double taxation resulting from Action 2 recommendations would be inimical to global commerce.

5.3.2. **e** (minimise the disruption to existing domestic law). The Action 2 recommendations propose some radical changes that will require certain jurisdictions to significantly adjust other parts of their tax legal system.

5.3.3. **f** (be clear and transparent in their operation). The recommendations raise a variety of issues that will be subject to interpretation and adjustment by each jurisdiction, based in part on historical development of the relevant tax system, whether it is rules-driven or principle-driven, and in part on the extent of the taxing authorities' knowledge of other tax systems.

5.3.4. **h** (be workable for taxpayers and keep compliance costs to a minimum). Compliance with complex rules based on these recommendations will be burdensome, particularly to the extent that various jurisdictions do not coordinate their rules. Many taxpayers do not have the personnel capacity to deal with such complex rules.

5.3.5. **i** (be easy for tax authorities to administer). The Action 2 recommendations essentially require each jurisdiction to have total

knowledge of every other jurisdiction's tax system and be able to track every use of a hybrid arrangement.

5.4. In general, PwC advocates Action 2 recommendations that are simple and targeted to specific situations. The approach of simply looking for mismatches in tax treatment that result in lower aggregate tax needlessly widens the scope of the anti-hybrids package and materially increases the complexity of the proposed measures.

5.5. The recommendations are very ambitious and will require complex changes in the domestic tax laws that will lead to a significant compliance burden for taxpayers and tax authorities, who will need to aware of the tax treatment in the hands of the recipient of future payments. In the case of imported mismatches and reverse hybrids, they would even need to know the tax treatment of payments in the hands of parties other than those who contracted with one another.

5.6. There must be appropriate balance between double non-taxation and double taxation. This concerns both existing double taxation and potential additional double taxation resulting from the proposed hybrid mismatch rules. For instance, in the context of CFC loans, no account appears to have been taken of taxation of payments under CFC rules of the lender's parent company jurisdiction. Specifically, there should be no hybrid mismatch to the extent a deductible payment is included in income as a deemed dividend (or as ordinary income) under the CFC rules of the lender's parent company jurisdiction. Similarly, there should be no hybrid mismatch to the extent a deductible payment is reported in the ordinary income of the lender's home country as taxable dividend income resulting from an actual remittance of all or part of that deductible payment to the lender's home country (certainly on a current basis but arguably even in a future year).

5.7. Although the OECD seeks to create a multilateral approach to hybrid mismatches, the proposal of both a primary rule and a secondary or defensive rule may be interpreted variously by different jurisdictions, in a manner that could create undue complexity and a competitive disadvantage for some countries fully adopting the Action 2 recommendations.

5.8. To avoid this possible complexity and variation in competitive impact, we believe that the Action 2 recommendations should propose a primary rule only and drop the secondary or defensive rule. This approach would mean that the jurisdictions enacting legislation based on the recommendations would apply the primary rule to payments between companies operating in their respective countries. However, absent reciprocity, they could continue to apply effective existing (pre-Action 2) legislation to payments to and from jurisdictions that did not adopt the recommendations. This approach would not only eliminate any competitive disadvantage for compliant jurisdictions, it would also make changes in domestic legislation less complex and alleviate the compliance

burden.

5.9. Imported mismatches and reverse hybrids are a new addition to the hybrids paper issued in 2012. The nature of the information required by the payer in circumstances of imported mismatches and reverse hybrids is significantly more detailed with respect to the tax treatment in the foreign jurisdiction and the way the payment has been treated by the intermediary. The Discussion Draft acknowledges there are a number of tax policy and detection challenges presented by these mismatches that point towards a more limited scope when denying the deduction for the payer. It would be very useful to expand on these circumstances.

5.10. The imported mismatch rule can lead to cases of double taxation and disputes concerning allocation of taxing rights both in absolute and proportional terms. Take, for example, a treasury company, where a hybrid arrangement may exist for any number of tax and non-tax reasons. That treasury company could well have raised capital from a number of other sources and could be making ordinary course loans to dozens of companies around the world. If the countries directly involved in the hybrid mismatch arrangement do not adopt the primary or secondary hybrid mismatch rules, the dozens of countries in which companies are making deductible payments to the treasury company could *all* assert the defensive imported mismatch rule with respect to their respective *entire* deductible payments, depending on the size of the payment on the hybrid arrangement. It is not difficult to envision that the sum of these disallowed deductions could be many times greater than the income that is not included in income by the entity receiving the hybrid payment from the treasury company.

5.11. Even in a case where no double taxation arises, the Imported Mismatch rule raises difficult issues regarding the allocation of taxing rights among jurisdictions. Specifically, if the country receiving the hybrid payment, and the country from which the payment is made respectively decide neither to include that payment, nor deny a deduction, should a third country from which there is a non-hybrid payment be entitled to deny an otherwise allowable deduction? The imported mismatch rule has a very high likelihood of creating double taxation, enormous complexity in administration, and an increase in bilateral disputes regarding the allocation of taxing rights. For these reasons, we suggest that the imported mismatch rule be removed from the proposed hybrid mismatch rules. It is our view that the tax base of the source jurisdiction in these circumstances is better protected and administered through the workstreams of the other Action Plan items, especially with regard to interest deductibility and treaty access.

5.12. If the imported mismatch rule cannot, for whatever reason, be eliminated in its entirety, we would suggest that its scope be narrowed considerably. For example, it could be completely replaced by an imported mismatch anti-abuse rule, which is non-automatic in application. Specifically, a country wishing to assert the imported mismatch anti-abuse rule would have the burden of proof to

show that a hybrid arrangement undertaken in other jurisdictions circumvents hybrid rules in that country. Only in those circumstances would a proportionate denial of deductions be warranted.

5.13. Furthermore, we would question why it is necessary, where collective investment arrangements (including CIVs, Private Equity and other pooled investment vehicles) are concerned, to have a requirement for the secondary rule. Often, there is no controlling economic investor, and the intermediary and investor would not be all members of the same control group. The challenges are illustrated by paragraph 189, which states,

> In any situation, however, where the secondary rule applies, the entire deductible hybrid payment will be subject to restriction regardless of the amount of duplicate deduction that arises in the other jurisdiction. This has an implication for funds and other widely-held asset holding vehicles that are treated as entities under the laws where they are established but may be treated as transparent under the laws of the investor's jurisdiction. In particular, from a scope perspective, it may be unduly burdensome for such a hybrid entity to lose the full benefit of its deduction under the hybrid mismatch rule simply because a minority foreign investor has, without the consent or knowledge of the entity or fund, claimed a deduction for a portion of that expenditure under the laws of its own jurisdiction.

We agree strongly with this last sentence.

5.14. The Treaty Discussion Draft recommends following the recent trend of bilateral tax treaties, applying rules to payments to hybrid entities that ensure withholding tax reductions provided by treaties can only be claimed by residents subject to tax in a treaty jurisdiction. However, there is no discussion of how the hybrid mismatch rules should interact in cases where withholding tax is imposed on cross-border payments. It would appear to us that the imposition of withholding tax is at least single taxation, and that there is no need to engage the hybrid mismatch rules when withholding tax is applied. The Discussion Draft does not explain what happens with tax credits when there is a forced income inclusion, although we assume that a credit would be allowed for any direct tax.

5.15. PwC observes that the European Commission proposal to amend the Parent-Subsidiary Directive adopts the secondary rule as the only way to neutralise the tax treatment of hybrid financial instruments. We note that the EU proposal is therefore inconsistent with the OECD approach. See also Section 9 below.

## 6. **Workability and compliance**

6.1. The Action 2 proposals make different suggested recommendations for different situations, with primary, secondary, and sometimes defensive rules. These proposed rules exhibit great complexity with respect to the scope of inclusion, timing issues and definitional issues. Many jurisdictions will encounter challenges in implementing these complex rules within existing frameworks of domestic laws that all have their own historic background and policy objectives.

6.2. In addition, the high level of complexity creates a significant risk that the Action 2 recommendations will prove too difficult to administer in practice, for both tax authorities and taxpayers. This risk is likely to be exacerbated to the extent that jurisdictions fail to coordinate multilaterally as the OECD intends. Divergent and uncoordinated domestic rules enacted by various jurisdictions will create substantial compliance burdens for taxpayers and potential confusion among jurisdictions that seek to carry out the purposes of the Action 2 recommendations.

6.3. We agree that the Discussion Draft adopts the right general approach to modifying the definition of hybrids by excluding circumstances where a difference in taxation arises due simply to the timing of taxation between jurisdictions. There are commercial circumstances where a deduction arises in the jurisdiction of the payer but is not included immediately in the income and gains in the jurisdiction of the payees. This instance is illustrated in the draft at paragraph 88, which states; "The recommendation is not intended to impact on questions of timing in the recognition of payments. Thus, a hybrid mismatch does not arise simply because the issuer accrues original issue discount over the term of the bond while the holder only recognizes the corresponding income as redemption premium once the bond is repaid". This approach should mitigate the risk of double taxation, and we would suggest a stronger statement of these principles, together with specific examples of circumstances where the defensive rule would not be applicable.

6.4. In practice, the timing difference policy may give rise to complexity and legal uncertainty where a payer claims deductions currently in one jurisdiction (i.e., on an accrual basis) whilst a payee's inclusion in another jurisdiction may not arise until some later taxing period. This type of situation will put taxpayers and tax authorities in a position of uncertainty, not knowing what rules may apply in that later period. Consequently, tax authorities may act prematurely. A simple example of this point is where, under the primary rule, country B denies deductions in years 1 through 5 for payments on a hybrid financial instrument to a lender in country A. Country A adopts the secondary rule in year 3, and from that year forward taxes the payments as ordinary income. In such a case, the primary rule should not apply in years 3 and forward, yet it is unclear when (or whether) country B will be aware of the law change that occurred in country A. This complexity will be further exacerbated where deductions are given on an accrual basis on an instrument for which actual payment is deferred until a

later period. Even further uncertainty would arise when the context of this timing issue is extended to third jurisdictions as a result of imported mismatch rules.

6.5. In any case, the principle applied to timing differences should also be extended to circumstances where instruments are issued that are designed to trigger taxation in the hands of [taxable] investors only on realization of economic income and gains. The precise form of that taxable income in the hands of investors should not qualify this treatment. For instance, it should not be necessary for payments treated as interest income under the laws of the payer's resident jurisdiction to be taxed as interest income in the hands of an investor.

6.6. One specific example of an instrument that illustrates these tensions would be the Luxembourg CPEC (convertible preferred equity certificate). This is often an instrument that is treated as tax-deductible debt for Luxembourg accounting and tax purposes, but is often treated as equity under the laws of the investors' jurisdiction. This instrument would fall within the Discussion Draft's definition of a hybrid financial instrument, as it is expected to produce an annual tax deduction in Luxembourg but no taxable income in the non-Luxembourg investors' hands. As these circumstances most often arise in an intermediate holding company structure, Luxembourg would fall within the imported mismatch rules as country B. Paragraph 228 states that, by Country A or B adopting the 'other hybrid mismatch rules' recommended in the draft, the effect of imported mismatches would be eliminated and there would be no mismatch to import into Country C. These rules are ordered as:

6.6.1. Country A implementing CFC, foreign investment funds (FIF) or specific targeted anti-avoidance rules to tax on a current basis income of residents accrued offshore (in this example, through Luxembourg);

6.6.2. Country B preventing reverse hybrid entities (the recommendation on how to tackle imported mismatches is for universal adoption of the same set of hybrids rules, though it is also remarked that there will be typically little incentive on the part of the intermediary to introduce such measures);

6.6.3. Country C adopting a defensive rule to deny the deduction for the payment when certain conditions are satisfied, specifically only to the extent that a primary or secondary rule does not apply in the investor's jurisdiction (here, Luxembourg).

6.7. In the case of a widely-held private equity fund, it would be challenging in practice to demonstrate which jurisdictions qualify as 'Country A' and specifically whether a domestic dividend exemption applies. In many cases, the basic hybrids mischief 'to make income disappear' would not apply, because the holder does not have a dividend exemption system. Examples would include most ultimate individual investors and US based investors. This situation creates a real difficulty under the Discussion Draft proposals, as the

Luxembourg company would need to switch off the annual CPEC tax deduction, or the investor countries would need to tax the 'dry' income arising in Luxembourg. In both cases, a tax burden would fall on the investor significantly in advance of any real cash income or gains (or even tax income that never actually materialises). This situation is exacerbated by a seemingly narrow definition of 'ordinary income,' such that capital gains could be excluded and significant double taxation could later occur.

6.8. Further consideration needs to be given to the interaction with other Action Plan work streams. For example, what happens when Action 2 and Action 4 both deny some deduction for different reasons, or a treaty benefit is denied on a non-deductible hybrid payment? Whilst the Discussion Draft indicates that the hybrid mismatch rules should apply in primacy to domestic thin capitalization rules, this ordering rule does not cover all possible conflicts.

## 7. Scoping issues

7.1. We discuss further below the choice between a top-down and bottom-up approach, but in general we would strongly suggest the exclusion of widely-held, publicly-traded instruments and ordinary loans (either as issuer or holder), noting the very significant compliance burden for both taxpayers and tax authorities that would result if these instruments are drawn in routinely.

7.2. To reduce complexity and mitigate the risk of double taxation, we also strongly suggest that the proposed rules should generally not apply to unrelated parties. The threshold for defining 'related parties' should be an ownership interest of more than 50 percent. The proposal's threshold for what constitutes a related party (10 percent) is much too low. In the absence of central control over two or three entities involved in a transaction, a taxpayer that makes a payment to, say, a 20-percent related entity will not be in a position to obtain the information on the tax treatment in the hands of the recipient entity, or a third entity in the event of an 'imported mismatch' or 'reverse hybrid'.

7.3. We can appreciate that entities that are consolidated for financial accounting purposes represent members of the same control group.

7.4. The term 'related party' includes companies, funds and other entities and arrangements that would generally be expected to take into account the position of their non-portfolio investors (i.e. 10 percent or greater) when entering into their arrangements with those investors. The related-party test also includes relationships described as 'acting in concert' - parties that have a material interest in engineering a particular tax outcome with coordination mechanisms in place that allow them to undertake collective action. This includes shareholders or voting agreements, joint ventures and private equity funds under the control of a common manager all of which raise relationship issues that are similar to those presented by related parties and should therefore be treated in a similar manner. We question the contention that the payer,

intermediary and investor are truly all members of the same control group in such circumstances, and it is often not a simple matter for one party to the arrangement to determine the other parties' tax treatment of the same payment.

7.5. On this basis, we would suggest that such a rule will almost inevitably, when taken together with an imported mismatch rule, prevent a deduction for the payment in the payer jurisdiction in circumstances where a substantial proportion of ultimate investors are taxable. The intermediate entity is not a hybrid arrangement (taking the timing position as a separate question) but more a commercial necessity to pool and administer investment funds.

7.6. One basic test of a hybrid instrument or transfer in the domestic legislation Discussion Draft is the existence of a deduction with no corresponding taxation through inclusion as ordinary income. Paragraph 94 has some discussion of what is meant by inclusion as ordinary income, but essentially the Discussion Draft proposes leaving the determination to local jurisdictions. We are concerned that this approach could lead to wide diversity in application of the rules as between participating states, and we suggest that the Action 2 recommendations define the parameters of 'taxation of ordinary income' as tightly as possible. Such a definition could include dealing with situations of treatment as capital gain and the application of differing rules for income offset against losses. We would note that some jurisdictions (e.g., the United States) tax capital gains in a manner that is less advantageous than income that is defined as 'ordinary income.'

7.7. The 'top-down' approach that presumes every hybrid mismatch result is inappropriate and then carves out exceptions is likely both to be difficult to implement and to increase the level of uncertainty to a degree unacceptable to facilitate investment. We strongly urge a more limited bottom-up approach to the hybrid mismatch rule.

7.8. In addition, we would suggest that there is a much clearer separation between anti-hybrid measures applicable to instruments held by related parties and all other circumstances. The principle of applying the same rules to persons acting in concert and to unrelated parties entering into 'structured arrangements,' and then carving out the issuers of widely-held instruments, creates a multitude of implementation, information and technical concerns.

7.9. Our suggestion is to treat collective investment arrangements, such as private equity, real estate and other forms of pooled investment as a separate category, to take account of their specific facts and circumstances and the wide variety of investors by type, origin and tax status. We have outlined the reasoning behind this suggestion in further detail below.

7.10. In this regard, PwC refers to the recent OECD focus on Collective Investment Vehicles (CIVs), but notes that there is little recognition of that work in the

BEPS initiative. However, that focus has largely been on the retail fund industry, omitting from OECD's view other pooled investment vehicles that are not retail funds, but which play an increasingly important role in the global economy. This includes a broad range of funds that simply intend to pool investors similar to retail funds, such as funds focused on institutional investors.

7.10.1. The pooled investment vehicles are typically owned by a diverse category of investors, often including tax-exempt pension funds and governmental funds. The entity that serves as the pooled investment vehicle will frequently be a hybrid entity. These entities are usually not set up to benefit from mismatches, but are hybrid due to the diversity of investors in different jurisdictions and the diversity of jurisdictions these vehicles invest in. Such an arrangement is not based on aggressive tax planning, but merely the result of different rules in different jurisdictions. These pooled vehicles rarely result in 'double non-taxation'. Their goal is to make it possible for different investors to pool their investments without creating an additional layer of tax, i.e., tax neutrality (similar to regulated funds, CIVs).

7.11. Taking into account their diverse ownership and structure, these pooled investment vehicles may become innocent victims of anti-treaty shopping rules and anti-hybrid rules and therefore should be carved out from the BEPS work streams.

7.12. In such circumstances, we believe that any hybrid mismatch rules should only apply on a look-through basis to each investor (rather than tarring all of the investors in the pooled investment vehicle with the same brush) and, in any case, should not apply to unrelated parties.

7.13. One further consideration with regard to scope is that, as the Discussion Draft recognizes, the 'structured transaction' definition needs to be refined to ensure that only truly structured arrangements are included. In this regard, the definition should include a stipulation that pricing would be adjusted depending on tax outcome; a requirement merely that a tax outcome be priced in is too wide and will draw in too many transactions that are not tax-driven.

## 8. Repos and hybrid transfers

8.1. The Discussion Draft shows that, in a group context, hybrid transfers structured as repos or stock loans can achieve the same base erosion effect as hybrid instruments.

8.2. However, the examples in the Discussion Draft do not involve (or even resemble) ordinary market stock loan or repo transactions. Such transactions are a vital part of the provision of liquidity in world financial markets. Financial services institutions engage heavily in this market not just with third parties but

also in the ordinary course of intra-group business, typically to access pools of available stock or funds. Such market transactions will typically involve widely-held instruments issued by third parties.

8.3. Different domestic tax approaches to the characterisation of manufactured payments paid under such ordinary market stock loans and repo transactions may trigger the effect of the hybrid mismatch rules, notwithstanding the absence of any abuse of the sort targeted by the OECD's proposals on hybrid mismatches. This would lead to material uncertainty, and significantly increased compliance obligations (specifically the requirement to obtain a significant amount of information about the tax treatment of manufactured payments in the hands of counterparties). These burdens could have a significant and destabilising effect on the critical world markets, and we see no basis for applying hybrid mismatch rules to these ordinary market transactions.

8.4. We therefore suggest a total carve-out of repos and stock loans over widely-held third-party instruments except where a purpose test might reflect an abusive intent to a specific transaction.

## 9. Regulatory capital

9.1. The regulatory response to the financial crisis required banks and insurance companies to rebuild their capital bases and led to the evolution by regulators of classes of loss absorptive capital (including Additional Tier 1 Capital, or 'AT1', in the case of banks) having characteristics of both debt and equity, such as mandatory conversion to ordinary shares or mandatory write down in the event of financial stress triggers.

9.2. A number of tax authorities have clarified the treatment of AT1 capital, with some countries recently legislating to provide a deduction for the coupon on such debt. However, asymmetries remain between tax systems, with other systems adopting equity treatment for issuers and investors. This can create a hybrid mismatch in cross-border situations.

9.3. As the Discussion Draft recognises at paragraph 160, some regulators, in the interest of single point-of-entry resolution, prefer groups not to issue regulatory capital (including AT1) at the level of operating subsidiaries that have the capital requirement. They prefer that capital be issued at the parent level, with the AT1 then being passed down through the group to the relevant operating subsidiary by intra-group AT1 issuance. Commercial drivers may also make it more efficient for capital to be raised at the top parent level and passed through the group.

9.4. The policy goal ought to be that intragroup issuers of this form of regulatory capital should enjoy effectively the same tax treatment in regard to such instruments as similarly situated companies issuing direct to the market. An intragroup issuance of regulatory capital in country A by company X should

have the same economic effect for the group as a third party issuance of AT1 in country A by company Y. Otherwise, distortions or disincentives will occur and, most importantly, the regulatory objective of promoting these forms of capital and single entry point of resolution will be compromised.

9.5. The various forms of regulatory capital have been developed after very considerable work of regulators around the world and with the fundamental regulatory objectives of re-capitalising the financial sector and improving resolution mechanisms. Also, the tax treatments of these new forms of regulatory capital have been considered carefully by a number of tax authorities already (in the case of the UK, this involved a process of approximately three years). In our view, there are three reasons why we see no basis for intervening in or overriding the policy choices that have already been made in this area - whether by the regulators or domestic tax authorities. First, there is clearly a strong public interest in the significant process of recapitalising the banking and insurance sectors. Second, the area of regulatory capital is sufficiently ring-fenced as to mean there should be no impact outside the regulated bank and insurance sectors if regulatory capital is carved out from the hybrid mismatch regime. Third, there is overwhelmingly no abuse of the sort that the hybrid mismatch proposals are aimed at in relation to matters of regulatory capital.

9.6. We therefore suggest that the regulatory capital discussed above (whether issued direct to the market or intra-group) be excluded from the hybrid mismatch rules.

9.7. As regards issuance directly to third parties, our view above as regards widely-held instruments would mean that these are not subject to the hybrid mismatch rules.

## 10. EU freedoms and state aid

10.1. EU Member States will need to determine whether the implementation of these proposals in their domestic tax laws would violate EU free movement law. It is settled case law of the Court of Justice of the European Union (ECJ) that a limitation on the deductibility of payments that is contingent on the level of taxation of the recipient, restricts Articles 49, 56 and 63 of the Treaty on the Functioning of the European Union (e.g. Case C-294/97 Eurowings, § 35 *et seq*. and Case C-318/10 SIAT, § 25 *et seq*.; compare also Case C-196/04 Cadbury Schweppes, § 44-45). This principle would be relevant, for example, if one State would have to disallow the interest on a hybrid loan as a deductible expense upon application of the secondary rule because the corresponding interest income is not taxed by the State in which the recipient is tax-resident.

10.2. A restriction on EU free movement rules is permissible only if it is justified by an overriding reason in the public interest. It is also necessary, in such a case, that the restriction be appropriate to ensure the attainment of the objective in question and not go beyond what is necessary to attain that objective. In the

context of interest-capping rules, the ECJ has ruled that limitations on interest deduction beyond the arm's-length principle cannot be justified on that basis. In addition, taxpayers must be given the opportunity to provide commercial justification for a possible non-compliance with the arm's-length principle (Case C-524/04 Test Claimants in the C[illegible]). Case C-282/12 Itelcar, § 34 The ECJ has held that, simply because the recipient of a payment is subject to a favourable tax regime does not create a presumption of tax avoidance (Case C-196/04 Cadbury Schweppes, § 49, with reference to further case law). It would be advisable to provide persuasive arguments why hybrid mismatch rules restricting interest deductibility would be permissible under EU law, and in which circumstances they would apply. We stress that fewer EU law issues would arise if both States involved in a hybrid transfer apply the primary rule.

10.3. EU Member States will also need to determine whether the implementation of these proposals in their domestic tax laws would violate EU State aid law. According to Article 107(1) of the Treaty on the Functioning of the European Union, any aid granted by a Member State or through State resources, in any form whatsoever, which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods are incompatible with the internal market, insofar as it affects trade between Member States. Article 108(3) TFEU stipulates that the Commission must be informed of any plans to grant or alter aid. EU Member States may not put proposed measures into effect until this procedure has resulted in a final decision. If aid is granted in contravention of this rule, it is unlawful and can result in such aid being recovered from the beneficiaries thereof, reaching back over a period of 10 years.

10.4. State aid may neither be granted through a direct transfer of money to undertakings, nor through a relief of a financial burden which an undertaking would normally have to bear, such as taxation. This means that State aid may not be granted through measures in a tax code which make an exception to the 'normal' system of taxation, unless that exception has been notified to the European Commission and the Commission has approved it. In this context, it would be advisable to substantiate why a possible carve-out from hybrid mismatch rules for certain taxpayers would be permissible under EU State aid law. We would suggest discussing possible carve-outs with the European Commission alongside the current process.

## 11. Transition rules and grandfathering

11.1. The Action 2 recommendations make no mention of transition rules. This issue is important, given the many existing arrangements involving hybrid transfers and entities. First and foremost, it is essential that the Action 2 recommendations be coordinated with related Actions in the OECD BEPS process, specifically Actions 3 (on CFC rules), 4 (on interest deductibility), 5 (on harmful tax practises) and 6 (on treaty benefits). The Action 2

recommendations should emphasize that local countries not make hybrid mismatch rules effective before rules arising from recommendations in those other Actions are effective.

11.2. To the extent that the OECD maintains the Action 2 recommendations with respect to either unrelated or related transactions, PwC believes that they should be effective only for hybrid arrangements entered into after the respective enactment dates of the local country rules implementing the recommendations.

## 12. Treaty discussion draft

12.1. The preceding comments all address the recommendations made for domestic law. We have also reviewed the draft discussion paper addressing the treaty issues associated with hybrid mismatch arrangements. In our view, the issues raised there are not of the same magnitude as those with respect to the proposed domestic law provisions. Subject to the specific points noted below, we are in broad agreement with the approach that is proposed, although we consider it to be important that the question of treaty interaction is revisited once the proposals with respect to domestic rules are finalised, ensuring that the conclusions with respect to areas such as the interaction with non-discrimination provisions can be retested.

12.2. We would like to highlight two specific issues with the Treaty Discussion Draft. The first of these relates to the section addressing the imposition of tax on a non-resident with no permanent establishment in the taxing state. At paragraph 15 of the Treaty Discussion Draft, it is suggested that the proposed domestic rules do not contemplate the imposition of tax otherwise than in situations where the entity in question is either resident in the territory imposing the additional tax, or has a permanent establishment in that territory. We consider it possible that the proposed domestic rules addressing reverse hybrids could apply in a situation where the entity having the tax imposed is neither resident in, nor has a permanent establishment in, the territory imposing the tax.

12.2.1. One such example would be interest income arising in a US LLC held by a non-US parent. The US LLC is neither resident in the US nor does it have a taxable permanent establishment, since there is no income effectively connected with a US trade or business. The secondary rule addressing reverse hybrids would have the US impose tax on the LLC, but this is not the same as it being a US resident or having a US permanent establishment. In such a situation, a risk of double taxation may arise if the territory paying the interest to the LLC does not provide treaty relief due to the fact that the LLC is not resident in the US.

12.3. The second point is in relation to the discussion on pages 12 and 13 of the Treaty Discussion Draft, concerning the Exemption Method and the Credit Method. We recognise the challenges that departure from the standard versions of Articles

23 A and 23 B can give rise to, particularly in the context of the recommendation that exemption for dividend income denied where the dividend is deductible for the payer. In our view the most efficient way to address this issue is to revert to the Credit Method for the purposes of the treaty and then allow for further relief in the form of an exemption to be provided for under domestic law where the restriction on deductible dividends can be incorporated with relative ease.

## 13. Conclusion

13.1. Before Action 2 produces final recommendations, we suggest posing the question of whether the hybrid mismatch approach set out in the Discussion Draft is necessary, or whether strengthening interest deductibility rules and CFC rules (along with other related Actions) would secure for tax authorities the desired outcome of adequate protection against abusive double non-taxation.

13.2. If the answer to this policy question is that hybrid mismatch rules are still required, then we support the ultimate objective of an agreed set of hybrid mismatch rules, but these rules should be designed to negate only abusive situations. If this outcome can be achieved in an objective mechanical fashion, then we agree that this would provide greater certainty to both taxpayers and tax administrators. However we acknowledge the challenges in achieving this aim, and for this reason we consider it likely that the need for some motive or purpose test would still remain, perhaps as a backstop rule to be tested only after the application of the mechanical rules, to avoid unintended and inappropriate outcomes from the mechanical rules. This is especially the case in the context of the imported mismatch rules.

13.3. In any case, we believe it is imperative that work on the final design of these rules be delayed to take account of other OECD BEPS Actions, such as CFC rules, interest deductibility, treaty issues, and harmful tax competition, which have a critical bearing on this issue. This would not only allow compatibility with the proposals in the other relevant work streams but also allow a sensible further period of consultation to ensure the final recommendations reflect some of the difficult detailed comments made above.

13.4. In the interim, assuming the Action 2 report finalization cannot be tied into the other working groups' timetables, we believe that Action 2 should recommend rules focused solely on related-party transactions and accompanied by a subjective purpose test.

## Checklist of responses to specific questions for consultation

| Questions | Responses |
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| **1. Design of Hybrid Mismatch Rules** | |
| 1. Are the objectives and design principles of the hybrid mismatch arrangements clear? | See Section 5 above. |
| 2. If further clarification is required, then where is this required and how could it best be provided? | See Paragraph 5.3 above. Particular pressure is anticipated in respect of design principles d, e, f, h and i. |
| **2. Hybrid Financial Instruments & Transfers** | |
| 1. Is it clear what elements need to be present in order for the rules neutralising hybrid financial instruments or hybrid transfers to apply? | At a theoretical level, this is clear but, as noted below, our concern is with how these rules will operate as between different territories. |
| 2. Is the outcome of the rules' operation clear? | We consider there to be a considerable risk that the multi-tiered rules (primary, secondary and defensive), combined with the effects of locally differing implementation, will lead to significant complexity and a lack of clarity as to the practical outcome for any given structure. See Paragraphs 6.1 – 6.5 above. |
| 3. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations? | None identified. |
| 4. This document sets out two possible approaches to drafting a scoping rule and summarises the possible advantages and disadvantages. Are the advantages and disadvantages accurately described and are there any other advantages and disadvantages of the two approaches? | See Section 7 above. |
| (a) What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration? | See Section 7 above. |
| 5. This part includes a number of examples: - | |
| (a)What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties | See generally Sections 5 - 8 above. |

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| position? | |
| (b) In this context are there any examples or situations that are more problematic than others? If so please explain why problems arise and what constraints or restrictions the parties might face in obtaining relevant information on the treatment of the counterparty? | |
| (c) To the extent that there are difficulties, do these apply equally to both the holder and issuer in the context of hybrid financial instruments? | |
| (d)Are there any other situations or examples, not covered here that give rise to difficulties? In particular are there any specific problems for regulated businesses (see also Q. 8 below)? | |
| 6. What definition could be used to capture the concept of widely-held or regularly traded whilst also addressing concerns that any exemption should not be available to related parties, parties acting in concert or parties to a structured arrangement (i.e. an arrangement designed to obtain the benefit of a mismatch). | See Paragraphs 7.1 - 7.3 above. |
| 7. If the rule exempted certain traded instruments then how could it be drafted so that it still applied to structured arrangements? | See Paragraphs 7.1 - 7.3 above. |
| 8. In relation to regulatory capital | |
| (a)What are the regulatory requirements for banks' to issue/manage capital at top holding company level, and what arrangements are used to pass this down the group? For example, what use is made of identical and traceable instruments and under what conditions would the arrangement be funded by a market issuance at top holding company level? | See Section 9 above. |
| (b)Are special provisions needed to create parity between a banking group issuing hybrid regulatory capital indirectly to the market through its holding companies and a banking group (or another industry group) issuing hybrid regulatory capital directly to the market? | |

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| (c)Are hybrid regulatory capital instruments sufficiently different as to justify a full carve-out from hybrid mismatch rules? Are there inherent safeguards in place against the use of these instruments for tax-planning purposes or what safeguards could be introduced to ensure that any exemption from the general hybrid mismatch rules could not be abused? | |
| **3. Hybrid Entity Payments** | |
| 1. Is it clear what elements need to be present in order for the rules neutralising deductible hybrid entity payments to apply? | At a theoretical level this is clear but, as noted below, our concern is with how these rules will operate as between different territories. |
| 2. Is the outcome of the rules' operation clear? | We consider there to be a considerable risk that the multi-tiered rules (primary, secondary and defensive), combined with the effects of locally differing implementation, will lead to significant complexity and a lack of clarity as to the practical outcome for any given structure. See Paragraphs 5.1 - 5.3 above. |
| 3. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations? | None identified. |
| 4. Are there any related party structures where the hybrid entity may have difficulty in knowing or obtaining information about the position of the investor? | See generally Sections 5 and 6 above. |
| 5. If so when would these arise and what difficulties or constraints would the hybrid entity face? | See generally Sections 5 and 6 above. |
| **4. Imported Mismatches and Reverse Hybrids** | |
| 1. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations? | None identified. |
| 2. Is it clear what elements need to be present in order for the defensive rule neutralising reverse hybrids and imported mismatches to apply? | While in theory this can be clearly articulated, when the rules are put into practice we envisage significant complexity and an increased compliance burden. See above from Paragraph 5.5. |
| 3. How could an anti–abuse provision be drafted so that it prevents otherwise | See Paragraphs 5.10-5.13 above. |

| | |
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| unrelated parties from entering into arrangements to exploit mismatch arrangements? | |
| **5. Further Technical Discussion and Examples** | |
| 1. Do these technical recommendations assist in understanding and applying the rules? | The technical recommendations are helpful in gaining a better insight into what is intended and are a welcome accompaniment to the proposals. |
| 2. Are there further technical recommendations that should be addressed in the final report? | The technical discussions in the Discussion Draft are largely of a generic nature. As outlined above, it is our view that more consideration should be given to some of the real-life examples of how these rules might apply, and whether they are achieving the stated policy objectives in a proportionate manner. See, for example, Paragraphs 5.10, 6.4, 6.6 - 6.8, 7.2, 7.10, and 12.2.1 above. |

•SwissBanking

ASA | SVV
Schweizerischer Versicherungsverband
Association Suisse d'Assurances
Associazione Svizzera d'Assicurazioni

Mr. Achim Pross
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Per e-mail:
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Basel, 30 April 2014
St. 30 / JBR

**Discussion draft on Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)**

Dear Mr. Pross,

The Swiss Bankers Association and the Swiss Insurance Association, two leading professional organizations of the Swiss financial center, would like to take the opportunity to comment on Action 2 of the BEPS action plan.

First of all we emphasize that hybrid instruments play an important role for the highly regulated financial sector. Hybrid regulatory capital for banks subject to Basel III and for insurances subject to solvency will be addressed in more detail below, but it is important to recall at this stage some general facts illustrated by an example: most European insurance groups, especially life insurance groups, issue long-term debt instruments containing some hybrid features. The rationale behind it is that such instruments allow raising long-term capital in a form which is more flexible and cheaper than equity, while fulfilling regulatory capital requirements. Such instruments are subordinated to any claim policyholders may have in the case of bankruptcy of the insurance company. Frequently there will be one single issuer of such instruments within an insurance group: this is mainly due to the fact that one is seeking both to achieve the lowest interest rate and to simplify the issuance process to the financial markets. Often such instruments are then lent on a back to back basis to underlying subsidiaries requiring funds.

For the financial sector, operations containing hybrid elements are fundamental to achieve a capital structure in line with regulatory requirements and therefore great care must be taken not to disturb useful mechanisms allowing compliance with regulatory obligations.

We would like to make more specific comments on a number of issues addressed in the discussion draft.

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**1. General anti-avoidance rules vs. Rules specifically addressing hybrid mismatch arrangements (page 5)**

General anti-avoidance rules are considered to be less effective to fight against hybrid mismatches than rules specifically addressing such arrangements. We doubt it: according to our experience, rules which are difficult to implement are actually less effective than rules that can be more easily implemented. The specific rules addressing mismatch arrangements are complicated and might therefore be difficult to implement. We recognize, however, that any general anti-avoidance rule should be clear in prescribing the exact circumstances when it can be used in order to provide certainty; official guidance might play an important role in this context.

**2. Double Taxation (page 12)**

We think that through the introduction of an automatism but also because of the complexity of the rules designed to prevent mismatches, there is a risk that taxation might occur twice and that double taxation will not be corrected automatically: according to us, the co-ordination of rules proposed does not represent a well defined process. We do not think that increasing the risk of double taxation is appropriate in a context where globalization takes place to the benefit of all, including of the emerging economies: double taxation might prevent economic development.

Many instruments issued by banks and insurance companies have similar if not identical terms, due to the commercial and regulatory requirements that drive the structure of such instruments. The risk of mismatch or double taxation could be materially reduced if OECD members and treaty partners could set out clearly their tax treatment of particular instruments, e.g. Tier 2 debt instrument issued under Solvency 1, so both taxpayers and tax authorities can directly identify the appropriate tax treatment for both lender and borrower (see also our point on hybrid regulatory capital).

**3. Related Parties (page 34)**

The 10% threshold for considering a person a related person is too low. We should rather have a 50% threshold, which allows full consolidation according to IFRS. With a participation representing less than 50%, there is no full control and hence no actual possibility to influence. For that reason also, any instrument issued and traded on a recognized stock exchange, as many such instruments are, should be exempt from the hybrid mismatch regulations.

**4. Acting in concert (page 35)**

We strongly disagree that the simple fact of acting in concert (as well as being related parties) are sufficient to apply the financial instrument rule (§ 125.). This would mean that from the outset related parties or acting in concert are considered as being suspicious and abusive, which implies to take automatic correcting measures, without any further consideration.

**5. Definition of structured arrangements (§ 131., page 35)**

Concerning the indicator of structured arrangement described at point (a):

"(a) an arrangement which was developed to exploit differences in the tax treatment; marketed as a tax-advantaged product or marketed to investors that would benefit from the tax arbitrage;"

as it is worded, this indicator might be overly broad since it prevents any tax competition, including on the level of tax rates. We consider that tax competition has positive effects and BEPS should not prevent it. The qualification of the tax treatment should be more specific in order to address actual mismatches.

**6. Exclusion of certain categories of instruments (§ 145., page 39)**

Hybrid regulatory capital should be excluded. As a principle all the instruments implying third parties should be excluded. In all cases, the loans to individuals should be excluded (see also our point on hybrid regulatory capital).

**7. "Widely Held" Instruments (page 39 ff.)**

It is difficult to find a good definition of "widely held". For that reason we think that it is better to stick to the "third party" concept and as a consequence any instruments issued and actively traded on a recognized stock exchange should be excluded.

**8. Hybrid Regulatory Capital (pages 41-42)**

Regardless of whether a "bottom-up" or a "top-down" approach is eventually adopted, it is important to note that hybrid regulatory capital deserves to be addressed separately, because it imposed to the business and does not reflect a business choice.

To deal with the issue arising from the fact that "countries have chosen to adopt different positions with respect to its taxation" (§ 159.) guidelines (of the OECD) should be developed or reference to accepted accounting standards (e.g. IFRS, US-GAAP for the definition of interest and the respective interest bearing instruments) should be made. A harmonization of the definitions qualifying the revenues would be the most appropriate way to address mismatches. We understand that for the time being, some banks issue regulatory capital domestically in order both to avoid any mismatch that could occur because of the different positions of countries with respect to taxation (as described in § 159.) and to take due consideration of the own pace of each country for introducing regulatory capital requirements. This represents a pragmatic approach; we do not think however that BEPS, in a globalized economy, should lead to a situation, where the financial sector adopts exclusively domestic solutions.

Banks and insurances should not be restricted in their use of hybrid capital which they need to fulfill their regulatory obligations. They should in particular be able to fiscally deduct a payment regardless of the fiscal treatment of this payment in the country of residence of the investors. Otherwise, in some cases payments made by banks and

insurances are fiscally deductible, whereas the same payment, only because it is made to a different person would not be fiscally deductible: such an approach leads to a non acceptable uncertainty for the business.

Banks have to comply with regulatory requirements with respect to equity such as Basel III, as mentioned in the document. Before having to comply with Basel III they had to comply with Basel II and they might in the future comply with other requirements including those of the Financial Stability Board. In that context new instruments are examined (e.g. bail-in bonds; see the Swiss Financial Market Supervisory Authority FINMA position paper). Insurances have to comply with regulatory requirements with respect to equity such as solvency.

For these regulated instruments, no mismatches are intended, these instruments are meant to fulfill regulatory obligations, they should therefore not fall under the scope of BEPS, a reference to (accounting) standards would however be necessary. We understand that this might take time; we do think however that it is advisable to address the issue properly, which is a challenge in a complex and fast moving environment, rather than trying to adopt rules that might eventually prove to be inadequate.

In addition, we would like to mention that regulatory hybrid capital for banks and insurances should not be regarded as constituting harmful tax practices because:

- The debt is issued to the capital markets with no connection between the issuer and the investor.
- Issuers are unlikely to know the identity of the investors in externally issued debt and will not be in a position to enquire about their tax position.
- The interest on such debt is a genuine cost born by the issuer.

To sum up, we are of the opinion that hybrid instruments issued to fulfill regulatory requirements, involving third parties, should not fall under the scope of BEPS. Potential mismatches stemming from the fact that countries have chosen to adopt different positions with respect to the taxation instruments should be addressed through a harmonization of tax qualifications at the level of tax administrations.

We thank you to take due consideration of our submission.

Swiss Bankers Association

Urs Kapalle Jean Brunisholz

Swiss Insurance Association

Lucius Dürr Marc Chuard

# TAX EXECUTIVES INSTITUTE, INC.



1 May 2014

Mr. Achim Pross
Head, International Co-operation
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Centre for Tax Policy and Administration
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**RE: Discussion Drafts on BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Law and Treaty Issues)**

Dear Ms. de Ruiter and Mr. Pross:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Action Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries' tax bases are being eroded or profits shifted improperly.

Pursuant to the Action Plan, the OECD issued two public discussion drafts on 19 March 2014, each of which addressed issues arising under BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements. One draft sets forth recommendations for changes to domestic law (hereinafter the Domestic Draft), and the other draft discusses certain treaty issues (hereinafter the Treaty Draft, together with the Domestic Draft, the Discussion Drafts). The Discussion Drafts discuss the policy issues that may arise from tax planning that utilises the

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differences in the tax treatment of instruments and entities across jurisdictions and sets forth recommendations to address those issues.

On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for comments on the Discussion Drafts.[1]

**TEI Background**

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 55 chapters in Europe, North America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 members represent over 3,000 of the largest companies in Europe, the United States, Canada, and Asia.

**TEI Comments on the Domestic Draft**

TEI commends the OECD for its discussion of the issues that arise from differences among various countries' tax laws. The Discussion Drafts, in general, accurately describe the compliance and financing challenges that multinational enterprises (MNEs) confront when faced with non-uniform tax regimes, as well as the structures and transactions MNEs employ to organise their business operations. If uniformly adopted, the solutions proposed by the OECD might well be effective in curbing the double deduction (DD) or deduction/non-inclusion (D/NI) transactions described in the Drafts. Regrettably, some of the suggested solutions are overbroad and administratively unworkable.

Hybrid entities serve a variety of commercial purposes. Thus, the scope of this action should be limited to the use of hybrid entities or arrangements that are inappropriate or abusive, based on objective criteria and bright-line tests. This would permit MNEs to use hybrid entities or arrangements in other cases. The recommendations in the Discussion Drafts, and in particular the Domestic Draft, are regrettably not limited to inappropriate or abusive cases. Indeed, the recommendations would include in their scope transactions that take place between unrelated parties in certain instances, which is overbroad an unnecessary.

Need for Consensus Approach

To be successful, BEPS Action 2 on hybrid mismatches requires a consensus approach. More than any other action in the Action Plan, hybrid mismatch transactions will merely migrate to those nations that fail to adopt the final recommendations or adopt them piecemeal.[2]

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[1] Our comments focus primarily on the Domestic Draft's recommendations. Brief comments on the Treaty Draft are on page 10.

[2] The Domestic Draft recognises this problem and states that it "recommends that every jurisdiction introduce[] a complete set of rules that are sufficient to neutralise the effect of the hybrid

This is especially the case for imported mismatches and reverse hybrids, which also present the more vexing administrative and compliance issues.[3] While planning involving hybrid instruments or entities may become more difficult and therefore less prevalent, it will continue and eventually will undermine the objectives of the countries that adopt the OECD's recommendations. Indeed, there is seemingly no mechanism to encourage countries to adopt the Discussion Drafts' recommendations about hybrid mismatch arrangements. Perhaps this will be addressed under BEPS Action 5 regarding harmful tax practices.

Even if countries uniformly adopt the Domestic Draft's recommendations, differences regarding the timing of when each country implements the recommendations will by itself lead to mass confusion and uncertainty. Thus, the recommendations should be adopted as nearly simultaneously as possible to avoid any such confusion or uncertainty. The OECD could recommend that the rules for domestic law only go into effect after a critical mass of countries has implemented the rules.

Further, the Domestic Draft presumes that there will be a high degree of co-ordination and communication between countries in the implementation of the domestic recommendations and the primary response and defensive rules. Owing to the complexity of the rules and varying fiscal objectives in each taxing jurisdiction, it is highly unlikely that there will be a consistent approach in the interpretation and application of the often overlapping rules, leading to pervasive double taxation. Indeed, there will be significant incentives for tax authorities to routinely assert the defensive rule without inquiring whether the primary rule has been applied. If a country were to discover that another country denied a deduction in a DD transaction, which country will ultimately permit the deduction and thus reduce its tax base? We submit that neither jurisdiction will readily recede to the other, even in cases where they have adopted the Domestic Draft's recommendations, leaving the taxpayer with no deduction anywhere.

Similarly, TEI is concerned that the uncoordinated use of the secondary measure by the recipient country in the described D/NI structures could easily lead to double taxation. Given that the D/NI structures includes a foreign income pick-up plus a timing benefit only, the indiscriminate use of income recognition whenever a D/NI structure is suspected could easily lead to double taxation. With respect to the primary response, a denial of the deduction may not be warranted in many cases and will lead to disputes with local tax authorities on audit, especially if the proof that the otherwise deductible payment has been included in the recipient's income is not accepted.

As a result, resolving the inconsistencies that will arise where different hybrid mismatch "remedies" are applied will put even more pressure on the competent authority process, which

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mismatch on a stand-alone basis, without the need to rely on hybrid mismatch rules in the counterparty jurisdiction." Domestic Draft at p.11.

[3] *Id*. at p.56-66.

seems to be the "catchall" solution to the difficulties that will arise when implementing the Action Plan's recommendations.

Impact of Deferral/Timing Differences

The Domestic Draft states that its rules do not apply to timing differences.[4] Yet, the tax savings in several of the examples of targeted transactions seem to result from timing differences or tax deferral. For example, the Domestic Draft describes a share subscription with a deferred purchase price, which is treated as giving rise to a deductible expense for a subscriber and a non-taxable receipt for the share issuer.[5] In this case gain will eventually be recognised because of the basis reduction in the shares due to the deduction; denying the deduction would merely accelerate the timing for tax purposes. Thus, in timing or deferral structures the delayed or deferred income will eventually be taken into account and taxed. If the deduction were denied at the inception of the transaction, then double taxation would result. TEI recommends that these kinds of deferral and timing differences be excluded from the scope of the proposed rules. If the transactions are not merely timing and deferral transactions, but are truly D/NI transactions, then the Domestic Draft should more fully describe the targeted transactions to allay confusion.

Targeted Approach of Recommendations and "Top-Down" *vs.* "Bottom-Up"

TEI commends the OECD for its approach of targeting only the tax effects of the use of hybrid mismatches rather than recharacterising the instruments or entities underlying the mismatch. That is, denying a deduction or forcing an inclusion solely for the tax effects that arise from the mismatch rather than requiring that a financial instrument be treated as debt for all tax (and other) purposes (or recharacterising a fiscally transparent entity as opaque in all cases) is an appropriately narrow approach. TEI also commends the OECD for not recommending a general anti-abuse rule to address hybrid mismatches. Such a rule would create unnecessary uncertainty and hinder economic growth.

With respect to the scope of the hybrid financial instrument rule, the Domestic Draft posits two possible approaches: a "top-down" approach and a "bottom-up" approach.[6] The top-down approach would apply to all hybrid mismatches, and then provide certain exceptions (*e.g.*, for widely-held and/or publicly traded instruments), and also exceptions to the exceptions (*e.g.*, excepted transactions entered into by related parties).[7] The bottom-up approach would only apply to instruments held between related parties (including parties acting in concert) and

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4 *See* Domestic Draft at p.26.

5 *See* Domestic Draft at p.20. Other transactions described on page 20 also appear to result in timing differences or tax deferral.

6 *See* Domestic Draft at p.32-42.

7 *Id*. at p.38.

hybrid financial instruments entered into as part of a "structured" arrangement.[8] TEI strongly recommends that the OECD adopt the bottom-up approach.

An approach that applies to any and all hybrid financial instruments (other than a narrow class of excepted transactions) is simply unworkable for the reasons detailed in the Domestic Draft. As the Draft notes, under a top-down approach the "hybrid mismatch rule could apply . . . to any debt instrument that is held cross border (whether on initial issuance or following a transfer)."[9] This is problematic given the scope of today's global capital markets and cross-border investment flows. The Domestic Draft seems to recognise this, noting that the top-down approach would "impose compliance obligations on every person who is a party to an instrument unless those instruments are carved out of scope."[10]

A primary underlying issue is that while it is appropriate to require holders or issuers of financial instruments to determine the proper tax treatment of the instruments under the tax laws of the holder's or issuer's respective jurisdictions, it is not appropriate to require them to determine the tax treatment in the counterparty's jurisdiction (or potentially multiple jurisdictions if there is more than one foreign holder). As the Domestic Draft notes, the latter would require obtaining foreign tax advice on the treatment of the instrument in every counterparty jurisdiction, which would be an expensive and time consuming process. Moreover, holders would have to obtain information from the issuer, which may or may not be readily available or reliable. These complications only increase when an instrument is transferred from one holder to another in a different jurisdiction, which may create a hybrid mismatch when there was not one when the instrument was first issued.

While the bottom-up approach is more workable from an administrative and compliance standpoint, it has its own deficiencies. First, the ten percent threshold for determining whether parties are related is too low. The draft describes such holders as "non-portfolio investors." Hence, it appears this percentage was selected because it is generally the ownership threshold for determining when the "portfolio interest" exception from withholding taxes on interest no longer applies. (In other words, many countries exempt from withholding taxes interest payments to foreign holders where the holder owns less than ten percent of the issuer.) If the assumption is correct, the Domestic Draft regrettably proceeds from the mistaken premise that a ten-percent holder will in all cases be able to obtain the information necessary to determine the application of the hybrid financial instrument rule. In many cases, obtaining such information will be difficult, perhaps impossible, for a ten-percent holder. TEI recommends that the OECD use an ownership threshold of 50 percent or more, which is generally the threshold used to determine relatedness for transfer pricing purposes.

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8 *Id*. at p.34.

9 *Id*. at p.39.

10 *Id*.

Second, the rule for determining when persons are considered to act in concert is overbroad. The general rule provides that "a person who acts together with another person in respect of ownership or control of any voting rights or equity interests will be treated as owning or controlling all the voting rights and equity interests of that person."[11] Persons will be treated as acting together with respect to ownership and control of voting rights and/or equity interests if, among other things, the "ownership or control of any such rights or interests are managed by the same person or group of persons."[12] TEI recommends narrowing this portion of the rule with respect to when persons will be treated as "acting together." As written it appears to apply to all of the funds that are managed by the same investment company and to all of the trusts managed by the same trust company. TEI recommends that this portion of the "acting in concert" rule include a requirement that a primary consideration to invest in an instrument was to obtain a DD or D/NI tax benefit.

A final administrative issue, which would apply under either the top-down or bottom-up approach, is that modifying the tax effects of hybrid mismatches raises complications for financial reporting purposes. An instrument that is generally debt for tax purposes is expected to produce deductible interest payments for financial reporting purposes. Under the proposed rules, however, the interest payments may not be deductible depending on the identity and residence of the holder of the instrument (*e.g.*, Is the holder related or unrelated for purposes of the rule? In which jurisdiction does the holder reside?). Since the holder of an instrument can readily change, the compliance challenges for subsequent holders of more-than-10-but-less-than-50-percent interest will be exacerbated. At a minimum, the final rule should more closely align the definition of relatedness with that of "control" used for consolidated financial reporting purposes.

Definition of "Exemption"

Among the primary targets of the Domestic Draft are deductible payments that are "not included in ordinary income of the holder's jurisdiction."[13] For this purpose, "ordinary income . . . means income that is subject to tax at the taxpayer's full marginal rate and does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular categories of payments (such as credits for underlying tax paid by the issuer)."[14]

This definition, while helpful, leaves certain questions unanswered. For example, is an exempt dividend payment that is only 95 percent "exempt" (*i.e.*, five percent taxable) considered exempt under this rule? Similarly, is a payment that is subject to a five-percent rate of tax considered to have been "incorporated into a calculation of the recipient's net income under the laws of the relevant tax jurisdiction" as required by the Draft?[15] What if the payment

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11 *Id*. at p.35.

12 *Id*.

13 *Id*. at p.27.

14 *Id*.

15 *Id*.

is untaxed as a result of the distributee's (or payee's) unrelated foreign tax credits (*i.e.*, credits that are not for the underlying tax paid or withheld by the dividend payer)? How would temporary benefits be treated under this rule? For example, in 2004 the United States enacted a one-time tax incentive to encourage U.S. companies to repatriate tax deferred foreign earnings.[16] The tax incentive came in the form of an 85-percent deduction for certain dividends received from foreign subsidiaries. Thus, these dividends were generally subject to a marginal tax rate of 5.25 percent (15 percent of the 35 percent U.S. corporate tax rate). It seems that under the definition in the Draft the dividends were "incorporated into a calculation of the recipient's net income" under U.S. law as required, but the dividends could also be seen as benefiting from "other tax relief." In other countries, whether dividends are taxable depends on how and where the dividends arise. A dividend may be fully exempt if it is paid from a subsidiary in a treaty-partner country and is paid out of active income. But if the dividend is paid from a subsidiary in a non-treaty country, the dividend may be taxable if the underlying tax rate is less than the parent company's rate. It is not clear how the definition of ordinary income applies in these cases. Thus, TEI recommends that the OECD expand its discussion of what it means for income to benefit from any exemption, exclusion, credit, or other tax relief.

Bias against Internal Leverage

Many of the examples of tax planning through hybrid mismatches in the Domestic Draft involve either the use of internal leverage (*i.e.*, debt instruments) or examples where the leverage itself is a hybrid instrument (*i.e.*, the financing instrument between related parties is treated as debt in one jurisdiction and equity in another jurisdiction). Further, the recommendations under BEPS Action 4 will address base erosion issues that arise via interest deductions and other financial payments. In addition, statements from certain OECD officials have indicated that the OECD is contemplating imposing limits on the use of internal leverage by business, possibly by limiting such leverage by reference to the amount of the MNE group's third party debt.

TEI opposes limiting the amount of a MNE group's internal leverage by reference to the group's third party debt. Such an approach would only encourage an MNE to incur more external debt than it otherwise would. In addition, the approach would place some businesses at a significant commercial disadvantage *vis-á-vis* their competitors.

Responses to Selected Questions regarding the Domestic Draft

The Domestic Draft sets forth several specific questions for consultation.[17] Although we continue to study the questions, TEI's responses to certain questions are provided below:

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[16] *See* 26 U.S.C. Sec. 965.

[17] *See* Domestic Draft at p.78-79.

1. Design of Hybrid Mismatch Rules

*Are the objectives and design principles of the hybrid mismatch arrangements clear? If further clarification is required, then where is this required and how could it best be provided?*

It is clear that the objectives of the hybrid mismatch rules are, in general, to deny the benefits of DD and D/NI transactions. Further clarification could be provided by delineating how two countries that simultaneously apply their domestic anti-hybrid instrument rules can easily coordinate their application. More broadly, if there are specific hybrid mismatch transactions that the OECD is targeting and believes are harmful, those transactions should be explicitly listed and described in Domestic Draft to assist tax authorities in applying the rules and place taxpayers on notice that these transactions will be subject to the new anti-hybrid rules.

2. Hybrid Financial Instruments & Transfers

*Is it clear what elements need to be present in order for the rules neutralising hybrid financial instruments or hybrid transfers to apply? Is the outcome of the rules' operation clear?*

It is generally clear what elements need to be present for the anti-hybrid rules to apply. TEI commends the OECD for producing targeted rules that are generally precise, which is preferred to a recharacterisation approach or an anti-abuse rule. The outcome of the rules, however, is not always clear, creating a significant risk of double taxation from countries applying the rules without coordination or inconsistently with each other. Administering the rules will require tax authorities to be much more knowledgeable about the design, implementation, and application of foreign tax laws than such authorities are currently. Misunderstandings of foreign tax law will inevitably lead to disputes and controversy.

*This part [of the Domestic Draft] includes a number of examples: (a) What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties position?*

As mentioned above, a commercial difficulty in the application of the hybrid rules is their impact on financial accounting when the hybrid rules, for example, deny a deduction. While this difficulty may be manageable in a related party transaction, it will be exacerbated when the parties lack the necessary information to determine the application of the hybrid rules, such as when an instrument is transferred between holders. Indeed, the correct application of the rules may not be determined until after a competent authority or court proceeding. The uncertainty in such a case is caused by the issuer's lack of information about an unrelated holder (or holders), and would not be caused by the application of the hybrid rules (*i.e.*, it is a factual uncertainty, not a legal one). Thus, this may be yet another situation where the financial accounting rules require taxpayers to book a reserve until the necessary information is acquired. While this would not be an unusual result for financial reporting

purposes, taxpayers prefer to be able to accurately reflect the tax consequences of their transactions in their financial statements on a timely basis.

3. Hybrid Entity Payments

*Is it clear what elements need to be present in order for the rules neutralising deductible hybrid entity payments to apply?*

The use of hybrid entities is much more prevalent by MNEs headquartered in certain countries than those headquartered elsewhere. The domestic law of such countries classifies the entities, and the classification in turn may determine whether or when income is recognised or deductions permitted. In addition, the overall tax consequences of transactions using hybrid entities often depend on the nature of the underlying tax system. For example, if an MNE is headquartered in a country with a worldwide tax system, then the income of the MNE's foreign branches is immediately subject to current tax. In contrast, in a territorial or exemption system, the foreign branch income is exempt. In these circumstances, there is a potential for a "double inclusion" if the income is taxable locally and also in the MNE's home country (the inclusion would generally be mitigated by a credit for taxes paid in the foreign jurisdiction, but not always). Thus, the results of the application of the hybrid entity rules are dependent on the underlying tax system of the country applying the rule. In many cases the rules may work well, but in many cases they will not. The OECD should recognise that the rules it recommends to address the use of hybrid will not always produce uniform results.

*Is the outcome of the rules' operation clear?*

As noted, application of the hybrid entity payment rules poses a significant risk of double taxation because of differences in the underlying tax systems of certain countries, as well as inconsistent and uncoordinated application of the rules.

4. Imported Mismatches and Reverse Hybrids

*How could an anti–abuse provision be drafted so that it prevents otherwise unrelated parties from entering into arrangements to exploit mismatch arrangements?*

Anti-abuse rules are extremely difficult to apply consistently absent accepted and well-developed guidelines. In many cases, these guidelines consist of common law developed through court decisions across multiple decades. Anti-abuse rules and doctrines are therefore best left to local countries to adopt and implement, and even then only in narrowly targeted situations. Should the OECD decide to recommend an anti-abuse rule, it should only apply in narrowly targeted cases of abuse, and be accompanied by strict, bright line rules delineating when tax authorities may assert the rule.

**TEI Comments on the Treaty Draft**

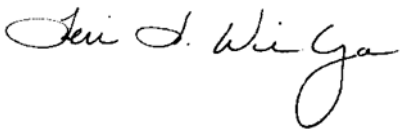
TEI opposes the use of bilateral tax treaties to address otherwise legal tax planning, as contemplated by the Treaty Draft. Tax treaties promote trade and direct foreign investment because they relieve double taxation; they have also been used increasingly to combat illegal fiscal evasion. The OECD's approach under this action and other action items in the Action Plan, such as Action 6 regarding tax treaty abuse, would expand the use of bilateral tax treaties into a new realm as tools for taxation where, in the absence of the treaty, such taxation would not otherwise occur.[18]

While TEI agrees that double non-taxation should be confronted, the OECD should be wary of making treaties a tool for combatting tax planning. In TEI's view, it will be difficult in many jurisdictions to effectively utilise treaties in this manner, either due to resistance by the legislature or the courts. That said, if a hybrid mismatch arises because of a treaty, then a simple remedy would be to change the relevant provisions of the treaty or prevent the treaty from being invoked in such cases. This is a more appropriate approach to such issues than turning treaties into an "all-purpose" tool to address disfavored tax planning. Use of tax treaties beyond this approach should be limited to reducing the difficulties that will arise when coordinating the anti-hybrid rules across two countries, such as by providing expedited mutual agreement procedures to resolve such issues and tie-breaker rules.

**Conclusion**

TEI appreciates the opportunity to comment on the OECD Discussion Drafts regarding hybrid mismatch arrangements. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +352 26 20 77 46, nickha@herbalife.com, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
**TAX EXECUTIVES INSTITUTE, INC.**



Terilea J. Wielenga
*International President*

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[18] TEI submitted comments to the OECD on BEPS Action 6: Prevent Treaty Abuse on 8 April 2014. TEI's comments are available at: http://www.tei.org/news/Pages/TEI-Comments-on-OECD-BEPS-Action-6-Prevent-Treaty-Abuse.aspx.

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May 1, 2014

Mr. Achim Pross
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Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
2 Rue André Pascal
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France

*Via e-mail to* aggressivetaxplanning@oecd.org

Dear Mr. Pross:

TD Bank appreciates the opportunity to submit comments on the OECD's Discussion Drafts on BEPS Action 2: Neutralize the Effects of Hybrid Mismatch Arrangements issued March 19, 2014.

The ability to raise capital and finance operations and expansion is critically important to the success of any business. In today's globally integrated economy, where cross-border business activity is the norm and capital is mobile, financing decisions are global decisions. And nowhere are the issues with respect to global financing more important than to global financial services businesses, which both make financing choices regarding their own highly leveraged operations and also act as intermediaries facilitating the financing of other global companies.

It cannot be denied that tax laws impact decisions regarding financing mechanisms. The disparate tax treatment of debt and equity under the domestic tax laws of many countries affects the costs of different financing options and can be a determining factor. Cross-border

financing arrangements are affected by the tax rules of two or more countries, adding a further dimension to the disparate tax treatment that can affect financing decisions.
We appreciate the tax policy concerns that underlie the BEPS Action on hybrid mismatch arrangements and that inform the proposed approach set forth in the Discussion Drafts. Our detailed comments attached address key technical issues on which input was sought. However, before turning to those technical comments, we would like to address the broader policy and practical considerations that we believe are critically important in the design of an appropriate solution.

As an overarching matter, we urge the OECD to limit the disruption of the financing decisions that are central to the operation of a global business. As in all things, care should be taken to ensure that the cure is not worse than the disease. In this regard, we would note that the construct laid out in the Discussion Drafts involving a coordinated set of primary and secondary responses and defensive rules to be applied by countries in a situation involving one of several different hybrid arrangements is extraordinarily complex. The complexity is increased exponentially when one considers that each country cannot simply enact this construct in a vacuum but rather must import it into the country's tax code and connect it to all of its existing rules relevant to the treatment of financial positions. It must be recognized that complexity itself represents a significant burden for taxpayers and for tax administrations. And the cost of complexity is a dead weight loss to the global economy.

The proposed construct of primary and secondary responses and defensive rules is centered on the domestic law treatment of the particular instrument in the two countries involved. As discussed in our detailed technical comments, a change in the domestic law of one of the countries involved can cause the proposed solution to lead to double taxation rather than the elimination of double non-taxation. Therefore, stable domestic law is a necessary prerequisite for the OECD's proposed construct to operate as intended. Accordingly, the work on this Action should not proceed without due regard being given to the work on several other Actions that have implications for the domestic tax treatment of financing arrangements, including most particularly Action 4 on limiting the deductibility of interest. Any changes in domestic law rules on the deductibility of interest expense will affect the operation of the proposed construct for addressing hybrid arrangements. Indeed, adoption of the recommendations that are the output of Action 4 could substantially reduce the incidence of hybrid mismatch arrangements to be addressed with the proposed construct. And the underlying issues may well be addressed in a more straightforward and comprehensive manner under Action 4 on interest deductibility than is possible under Action 2 on hybrids.

While we recognize that the due dates for these two Actions in particular are such that the work on hybrid mismatch arrangements is intended to proceed in advance of the work on interest deductibility, we believe the OECD should take a narrow and targeted approach to addressing hybrid arrangements so as to be able to reassess the need for further action after the work on interest deductibility is completed. As discussed in the detailed technical comments, a treaty-based approach would be one way to ensure hybrid rules that are tailored to particular circumstances. More generally, as further discussed in the technical comments,

use of the "bottom up" approach to defining the scope of the hybrid rules rather than the "top down" approach would allow the initial regime for addressing hybrids to be narrow and targeted in its coverage. This would be the most reasonable way to proceed while awaiting the relevant developments arising in connection with other Actions that are interconnected.

In conclusion, we urge the OECD to act cautiously in the area of hybrid mismatch arrangements, to take into account the solutions that could be developed under other relevant Actions, and to consider a phased approach to addressing hybrids under Action 2. Proceeding in this manner will help to limit complexity, increase stability, and foster a long-term solution that is fit for purpose.

We appreciate the opportunity to share these thoughts and the attached detailed technical comments on this important matter. We would be happy to respond to questions or provide any further input that would be useful as the OECD continues its work.

Sincerely,

Peter van Dijk
Senior Vice President, Tax
TD Bank

Attachment

**TD's Detailed Comments Addressing Key Technical Issues Related to BEPS Action 2 "Neutralize the Effects of Hybrid Mismatch Arrangements"**

The following represents TD's comments on the key technical issues raised in the discussion drafts addressing Action 2 of the BEPS Action Plan. The two discussion drafts (the "Domestic Laws Hybrid Draft"[1] and the "Treaty Issues Hybrid Draft"[2]) provide a thoughtful template for beginning a discussion about hybridity issues.

Our comments focus on the Domestic Laws Hybrid Draft and address two main areas.[3] First, we discuss the "design principles" described in the draft and describe several areas in which the design principles of critical importance to taxpayers—the avoidance of double taxation, clearness and transparency, and ease of application and compliance—should be given greater weight. For example, we note that the draft leaves critical definitions to the discretion of individual jurisdictions, which will create significant complexity, uncertainty for taxpayers, and the potential for double taxation, and suggest that the definitions be specific and consistent across jurisdictions. Second, we address the two alternative approaches for defining the scope of the hybrid instrument rules and recommend that a "bottom-up" approach be adopted. In connection with our recommendation of a "bottom-up" approach, we suggest that the proposed definitions of "related party" and "structured arrangement" be clarified and narrowed.

## I. The Draft Properly Recognizes the Need to Avoid Double Taxation and Provide Clear and Transparent Rules that Are Easy to Apply and Comply With, But Should Give These Principles Greater Weight

### A. Overview

TD appreciates the Domestic Laws Hybrid Draft's recognition that the "hybrid mismatch rules should meet the criteria for good rule design" (p. 10). The draft states that the rules should satisfy nine "design principles" by:

1. Operating to eliminate mismatch without requiring the jurisdiction applying the rule to establish that it has lost tax revenue under the arrangement ("DP1");
2. Being comprehensive ("DP2");

[1] OECD, Public Discussion Draft, BEPS Action 2: Neutralize the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws) (2014) ("the Domestic Laws Hybrid Draft").

[2] OECD, Public Discussion Draft, BEPS Action 2: Neutralize the Effects of Hybrid Mismatch Arrangements (Treaty Issues) (2014).

[3] Our comments mainly focus on the rules impacting hybrid financial instruments, but we note that thoughtful comments on the proposed hybrid entity payment, imported mismatch, and reverse hybrid rules have been made by others. For example, as others have commented, the imported mismatch rules are extremely complex, and the concerns animating those rules may be better addressed through rules targeting conduit financing arrangements.

3. Applying automatically ("DP3");
4. Avoiding double taxation through rule coordination ("DP4");
5. Minimizing the disruption to existing domestic law ("DP5");
6. Being clear and transparent in their operation ("DP6");
7. Facilitating coordination with the counterparty jurisdiction while providing the flexibility necessary for the rule to be incorporated into the laws of each jurisdiction ("DP7");
8. Being workable for taxpayers and keeping compliance costs to a minimum ("DP8"); and
9. Being easy for tax authorities to administer ("DP9").

TD emphasizes the draft's recognition that any rules addressing hybrid mismatches should be clear and transparent in their operation (DP6) and be workable for taxpayers (DP8). Certainty and clarity is key for business and the health of the global economy and local economies. If countries adopt unclear and complex rules, businesses will be less likely to make new investments and maintain their current ones. For the same reasons, it is also of critical importance that any rules avoid double taxation (DP4). An efficient, effective, and expeditious dispute resolution methodology, such as through treaty Mutual Agreement Procedures ("MAP") or otherwise, is also needed.

Although the Domestic Laws Hybrid Draft's attempt to describe and follow the design principles described above is laudable, the draft does not give adequate consideration to the design principles key to taxpayers, including the need to avoid double taxation, provide clear and transparent rules, and minimize compliance costs. We discuss below several aspects of the rules where we believe greater weight should be given to these design principles.

B. Lack of Clarity in Definitions Will Lead to Complexity and Further Asymmetry

The draft leaves critical definitions to the discretion of individual jurisdictions, creating significant complexity, uncertainty for taxpayers (thus undermining the OECD's stated intention of providing a set of coordinated and consistent rules), and the potential for double taxation. For example, the "hybrid instrument" rule applies in the case of a deductible payment made under a financial instrument that is not treated as ordinary income under the laws of the payee's jurisdiction.[4] This rule requires a determination of whether an instrument is a "financial instrument" as well as the tax treatment of payments under the instrument in

[4] The report's definition of hybrid instrument refers to "taxable income" in certain places and "ordinary income" in other places. *Compare* Domestic Laws Hybrid Draft, p. 15 (defining "hybrid financial instruments" as "where a deductible payment made under a financial instrument is not treated as taxable income under the laws of the payee's jurisdiction" *with* Domestic Laws Hybrid Draft, p. 25 ("Jurisdictions should deny a deduction for any payment made under a hybrid financial instrument to the extent that the payee does not include the payment as ordinary income under the laws of any jurisdiction."). Because the terms "taxable income" and "ordinary income" may have different meanings under domestic tax laws, we suggest that only one term be used consistently.

multiple jurisdictions, including how the instrument is characterized in each jurisdiction, whether a payment is "deductible" in the payer's jurisdiction, and whether a payment should be considered treated as "ordinary income" in the recipient's jurisdiction. Hybrid mismatches exist currently as a result of variations in countries' tax systems and laws. Failing to provide common definitions and scope to address those mismatches would give rise to additional asymmetries, complexity, and uncertainty.

Although we understand that the draft report aims to minimize changes to domestic law and provide flexibility to fit within existing domestic tax systems, we believe that the proposals should encourage countries to adopt rules that are more likely to result in consistent application. For example, the OECD could provide more detailed definitions to help minimize the extent to which there could be inconsistencies among individual countries' domestic laws.

Alternatively, the OECD could recommend that rules addressing hybrids be implemented, at least in part, through tax treaties rather than solely through changes to domestic law. This latter approach would have the benefit of promoting clarity and consistency, as countries could agree to a common definition of critical terms and use the MAP process to resolve ambiguities and any inconsistent application. This approach would also be simpler, as an agreed approach between two countries would eliminate the need for complex "secondary" or "defensive" rules applied where the other jurisdiction fails to apply the primary rule. The OECD could play a key role in developing amendments to the OECD Model Convention and Commentary.

C. Impact of Subsequent Recharacterization by Payor or Payee Jurisdiction

The proposed rules do not address the impact of future adjustments or reversals, adding complexity and increasing the prospect of double taxation, which is contrary to DPs 4 (avoidance of double taxation), 6 (clear and transparent operation), and 8 (rules should be workable and minimize compliance costs). For example, if the OECD proposal were adopted by both the payer and payee jurisdictions, a deduction for a covered payment on a hybrid financing arrangement may be denied in the payer jurisdiction. However, a country may nonetheless wish to recharacterize an arrangement in accordance with its own domestic law as an overlay to the automatic hybrid rules.

Subsequent recharacterization will cause uncertainty and possible whipsaw of taxpayers, especially given the timing issues presented when issues are raised on audit. Similar issues would also arise where a country changes its law.

For an example of the challenge presented by subsequent recharacterization, assuming a payment is not covered by the dividend exemption rule, the hybrid instrument rules may initially apply to a particular arrangement because a payment was treated as deductible in the payer jurisdiction and not includable in ordinary income in the payee jurisdiction. As a result, the payer jurisdiction may deny the deduction. Several years later, however, the payee jurisdiction may determine that the payment should have been included in ordinary income. If the payer jurisdiction prevents the taxpayer from recharacterizing the transaction, which may

occur if the payer jurisdiction statute of limitations is closed, the taxpayer will be subject to double taxation—its deduction in the payer jurisdiction will have been disallowed as a result of the hybrid instrument rule and its payment will have been required to be included in ordinary income as a result of the payee jurisdiction recharacterization. To prevent double taxation resulting from subsequent recharacterization, the OECD proposal could require that countries agree not to apply their general anti-abuse and re-characterization rules where the hybrid instrument rule results in either the denial of a deduction or an inclusion in ordinary income or where the statute of limitations has expired in the other country.

D. Coordination with CFC and Thin Capitalization Rules

The Domestic Laws Hybrid Draft acknowledges the instruction in the BEPS Action Plan Item 2 providing that any applicable CFC rules should be taken into account in determining whether a payment has been included in ordinary income.[5] Notwithstanding this explicit instruction, and DP4, which seeks to avoid double taxation, the draft report considers CFC rules only with respect to certain categories of hybrids (i.e., reverse hybrids, but not hybrid instruments). With respect to hybrid financial instruments, the draft states that it does not consider the impact of CFC or other anti-deferral rules "primarily due to concerns about workability and complexity of such a rule in that context" (p. 12) but does not specifically describe those concerns. But addressing the impact of CFC rules is no more complex than the core construct the OECD has proposed, and the failure to address such rules will lead to double taxation. Where a payment has been taken into account under CFC rules, it should be taken into account for all types of transactions consistent with the BEPS Action Plan and DP4 (avoidance of double taxation).

## II. The Report Should Adopt a "Bottom-Up" Approach to Defining the Scope of the Hybrid Instrument Rules

The Domestic Laws Hybrid Draft states that two approaches are being considered in defining the scope of the hybrid financial instrument rule. The first approach (a "bottom-up" approach) would include within its scope instruments held by related parties (including persons acting in concert) and "structured" arrangements deliberately designed to produce a mismatch. The second approach (a "top-down" approach) would begin with a broad rule that applies to all hybrid mismatches "other than those that fall within certain defined exceptions where it would be impossible or unduly burdensome for the taxpayer to comply with the rule" (p. 33).

[5] Domestic Laws Hybrid Draft, p. 5 (noting that Action Plan 2 states that model treaty provisions and recommendations regarding the design of domestic tax rules to neutralize the effect of hybrid instruments and entities may include "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)").

We recommend that the OECD take a bottom-up approach. All transactions between unrelated parties, except for structured arrangements, should be excluded. Unrelated parties not acting in concert and who have not entered into a structured transaction are not contributing to base erosion. Rather, any tax treatment mismatch in that instance is likely unintended and simply the result of variations in countries' tax systems and laws.

Applying the hybrid instrument rules to unrelated parties would give rise to significant complexity and create significant compliance and administrative burdens. For example, the proposed rule seems to envision that a payee's jurisdiction will remain the same during the entire term of an arrangement, but this is not necessarily the case. Most financing arrangements involve payments over time, and the instrument can be transferred to another holder or payee, whether individual or corporate, can change its residence. The issuer would be required to keep close track of any such changes and then determine whether the payment is to be included in the payee's ordinary income. This need to monitor would potentially require a change to the financial terms of an arrangement, if, for instance, an unrelated corporate entity were to change its residence (e.g. through a cross-border merger) to a jurisdiction that exempts the financing payment. Such a change might convert the payment from a deductible to non-deductible under the automatic rule, even if the transaction had been priced (from the payee's perspective) as if the payment were deductible.

Issuers and holders of publicly-traded or widely-held instruments would similarly face the negative consequences described above if the rules were applied to unrelated parties. It would be a significant compliance burden for issuers to track the residence of instrument holders and the rules of all jurisdictions in which holders are resident, possibly experiencing a changing financial position with respect to payments under the same arrangement every time a payment is made. Investors may choose to avoid such uncertainty, complexity, and potentially negative tax consequences by not investing in cross-border hybrid instruments, which could have a negative impact on capital markets. These difficulties could be avoided by taking the bottom-up approach and limiting the application of the rule to related party transactions and structured transactions.

The draft proposes a related party rule under which two persons are generally considered related if the first person has a 10% or greater investment in the second person or there is a third person that holds a 10% or greater investment in both. A person is treated as holding a 10% investment in another person if that person holds "directly, or indirectly through an investment in other persons," 10% of the voting rights of that person or the value of any equity interests of that person. The draft notes, however, that this definition "would need to be refined in accordance with local law while staying within the framework" of the definition (p. 35). The draft also states that the definition of related party "needs to be further refined under local law in order to deal with non-standard investment vehicles" (p. 35). It is unclear what "refined" means in this context. Without further direction from the OECD, the "refinements" to the definition made by countries could result in drastically different related-party rules among jurisdictions. We recommend that the OECD provide further direction to countries on the

application of the related-party rule rather than rely on individual jurisdictions to resolve ambiguities.

In addition, we note that 10% is a low threshold for related party status. Although the draft states that investors owning 10% or more should, "in general," have "sufficient economic stake in the issuer to obtain the information necessary to comply with the hybrid mismatch rule" (p. 34), 10% ownership is not necessarily non-portfolio investment. The OECD should consider increasing this threshold to an amount tending to indicate sufficient control or significant influence over the issuer and that reduces the potential for dispute between jurisdictions, such as 50%.

We also recommend that the definition of "structured arrangement" be clarified and narrowed. The discussion draft states that the term could be defined through a "list of readily identifiable factors that indicated whether a [transaction] was likely to have been engineered to produce a mismatch in tax outcomes" (p. 35). However, it is unclear whether the list of factors is intended to apply as part of a "facts and circumstances" test or whether a certain number of the factors must be present in order for an arrangement to be considered a structured arrangement. We recommend that the ultimate test provide a clear definition, the application of which is not left to the discretion of tax authorities. For example, the ultimate test could provide that all given factors must be satisfied.

The draft provides a list of five factors that "could" be included as part of a "structured arrangement" definition. We recommend that the list of factors be narrowed and clarified. Several of the factors are subjective and may be interpreted differently by tax administrators and taxpayers. For example, one factor looks to whether "an arrangement . . . was developed to exploit differences in the tax treatment" (p. 36), but it is unclear how one determines whether an arrangement "was developed" for such purpose. For example, is an arrangement considered developed to "exploit" differences in tax treatment if the differential tax treatment was a purpose of developing the arrangement, but not the principal purpose? In addition, several of the indicators are ambiguous and leave critical components undefined. For example, with respect to the indicator considering whether "the tax benefits are significant in proportion to the non-tax business and financial consequences of the arrangement" (p. 36), it is unclear what is meant by "significant" tax benefits and "non-tax business and financial consequences." Any factors used to define "structured arrangement" should be refined to, as the discussion draft states, "identify objective, readily identifiable features of an arrangement that comprehensively target arrangements that are undertaken by otherwise unconnected parties that are designed to produce a mismatch" (p. 36).

The draft also notes that a further scoping issue concerns the treatment of hybrid regulatory capital. As the draft recognizes, countries may adopt different positions with respect to the treatment of certain instruments used for regulatory purposes, including Additional Tier One capital. We recommend that the OECD proposal include an exemption for structures implemented by regulated financial services entities to adhere with regulatory requirements. Regulated financial service entities need access to a diverse source of funding in order to

improve liquidity and maintain the stability of the financial sector. Any instrument that is listed on a public exchange (or has the ability to be listed on a public exchange) and is ultimately widely held by arm's length parties should be excluded. In addition, an exemption should also take into account regulated financial service entities' need, in certain circumstances, to push down capital from the top holding company level to an intermediate holding company. As the draft itself recognizes, "as a result of regulatory requirements, banks are increasingly constrained in their ability to raise capital [through instruments issued directly to the market]. As part of a wider move towards a 'single point of entry' resolution, a number of regulators are encouraging banking groups domiciled in their jurisdiction to issue all their loss absorbing capital at top holding company level and then pass this capital down through the group to the relevant operating subsidiaries." (p. 42). An exemption should apply at the top holding company level as well as the level of an intermediary holding company.

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March 21, 2014

I have the following comments on:

Public Discussion Draft
BEPS ACTION 2:
NEUTRALISE THE
EFFECTS OF HYBRID
MISMATCH
ARRANGEMENTS
(Recommendations for
Domestic Laws)

It is unfortunate that the discussion draft does not adopt what seems to be a far simpler approach for hybrid entities. This approach would involve rules under which each jurisdiction would characterize an entity resident in a different country the same way (opaque or transparent) as the entity is treated in its home country. I have set forth the details of this approach elsewhere.

This rule corresponds better to the criteria (comprehensiveness and simplicity) identified in the discussion draft.

I would have no problem if the discussion draft were to reach the opposite conclusion, i.e. that for whatever reason the rule I propose would not be simpler or would be unworkable for whatever reason. However, I would think that the discussion draft should set forth the reasons for such a conclusion in some detail. This way, the analysis would be available for public scrutiny.

Victor Thuronyi

UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

May 2, 2014

VIA EMAIL

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**Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)**

Dear Mr. Saint-Amans,

The United States Council for International Business[1] is pleased to provide comments on the OECD's Discussion Draft on Neutralising the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws). We appreciate that the OECD is seeking early input on these important topics. USCIB supports the BIAC consensus comments. We will not repeat those comments here, but rather would like to emphasize some key points.

**Interaction with Other BEPS Action Plan Items**

The BEPS Action Plan items interact with each other. For example, changes to the rules concerning deductibility of interest expense, the application of CFC rules, treaty anti-abuse rules, and increased disclosure will all likely increase corporate tax payments and reduce the use of hybrid instruments and entities which will reduce the need for hybrid mismatch rules. Further, the proposed rules on hybrids and other BEPS action plan actions will increase both double taxation and the likelihood of double taxation. We believe that it is important to do an impact assessment of the effect of all of the proposed changes on cross-border trade and investment. Countries may collect some additional tax from companies, but some significant portion of those revenue gains may be offset by reduced foreign direct investment and the concomitant loss of jobs and spill over effects on their economies. These sorts of changes are not easily undone. So while we understand the OECD/G20's concern with double non-taxation, it is important to proceed with care.

[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.

## Complexity and Double Taxation

The rules proposed in the Discussion Draft are overwhelming complex and will be extremely difficult to administer. The rules assume a remarkable level of knowledge both on the part of taxpayers and tax administrations concerning the operation of foreign law and the way payments flow-through a structure. The proposed definition of a related person, which uses a 10% threshold, is too low for two reasons. First, depending on how stock attribution rules work, it will be difficult to know if different related entities that have minor ownership interests in the same entity together reach the 10% threshold. Second, if one entity owns only 10% of another entity, the information necessary to implement the hybrid mismatch rules simply will not be available. USCIB, therefore, believes that this threshold should be raised to at least 50%.

Fundamentally, however, the OECD has assumed that a problem that arises because sovereign countries do not agree on the tax treatment of certain instruments or entities can be resolved by sovereign countries agreeing on the tax treatment of hybrid mismatch arrangements. This strikes us as unlikely. A more likely outcome in our view is that the proposed rules will be adopted piecemeal by some countries, there will be significant differences in the way terms are defined, and uncertainty and double taxation will increase. One possible way of avoiding this piecemeal approach is to defer adoption until a critical mass of countries have adopted these rules. The Discussion Draft recognizes that one positive outcome from "dealing with hybrid mismatches on a multilateral and coordinated basis is that compliance costs would reduce significantly after a critical mass of countries adopts the same rule." (Para. 44) Since the Discussion Draft recognizes that workability and compliance costs are important design principles and adoption by a critical mass of countries will further these goals, the rules should not apply until a critical mass of countries have adopted the rules.

## Exemptions vs. Foreign Tax Credits

Most countries in the world have adopted territorial systems that follow the principle of capital import neutrality and exempt dividend income from residence country tax. The fundamental principle of capital import neutrality is that foreign companies operating within a jurisdiction pay tax at the same rate as domestic companies operating within that country and therefore foreign and domestic companies compete on a level playing field within that country. This is a fundamental choice made by countries to encourage the competitiveness of their industries in foreign markets. The consequence of this choice is to forego the potential additional revenue that would be paid on foreign source income of companies that are resident in that jurisdiction. The Discussion Draft, however, provides that "the payee jurisdiction should not be required to extend relief from economic double taxation under domestic law in circumstances where the payment has not borne underlying tax[2]." (Para. 84) This seems misguided to us because this is precisely why a country would choose to adopt an import neutral system: to give the benefit of the foreign rate reduction (including a reduction to zero) to the taxpayer to improve competitiveness in the local jurisdiction.

[2] This paragraph refers to the payment bearing tax, not being subject to tax. Countries that want to relieve double taxation only when the income has borne foreign tax adopt foreign tax credit systems, not exemption systems.

Some countries (including the US) have continued with a worldwide system with a foreign tax credit; this capital export neutral system is intended to create a level playing field between the choice of a domestic (US) investment and a foreign investment for a domestic (US) company.

The choice between capital import neutral systems and capital export neutral systems while leveling one playing field unavoidably "tilts" the playing field in another direction. That is, the capital import neutrality will encourage foreign investment, if the tax rate in the foreign jurisdiction is lower. Capital export neutrality will disadvantage a company from the export neutral jurisdiction against foreign competitors, if the tax in the capital export neutral jurisdiction is higher than in foreign jurisdictions. As discussed in more fully in our letter on the digital economy, companies do respond to these incentives in deciding where to locate productive investment, including decisions on where to locate company headquarters[3].

Why is this relevant to hybrid mismatch arrangements? Countries with import neutral systems have made a very fundamental policy choice; they have chosen to promote the competitiveness of their companies operating in foreign markets (and therefore have encouraged companies to make their headquarters resident in that country) over collecting residual tax on low-taxed foreign source income. This choice, and not the use of hybrids, is the root cause of much of the tax planning that countries find objectionable. Further, much of the hybrid planning US companies have engaged in is designed to achieve the effect of a territorial system even though the US has not adopted a territorial system. For a country that has adopted a capital import neutral system, the use of planning by taxpayers to achieve a similar effect should not be objectionable to that country.

**Withholding Taxes**

USCIB believes the hybrid mismatch rules should not apply if the payment is subject to withholding tax. There are two reasons for this conclusion. First, income that is subject to withholding tax is not stateless or non-taxed income. A lower rate of tax on gross income frequently results in a higher effective rate of tax than a net basis tax imposed at a higher rate. Second, it does not meet the D/NI standard set forth in the Discussion Draft. If the income is subject to withholding tax, it should not be subject to the hybrid rules at all because the predicate of deduction/no inclusion does not exist. The recipient of the income has gross income (interest, dividends and royalties are ordinary income, not capital gains) in the source country and therefore the rule, by its terms does not apply. Withholding is simply a mechanism for collecting tax; it does not change the nature of the income or the fact of liability. Taking the contrary view, imposing a withholding tax and denying a deduction, would clearly result in double taxation.

[3] See, New York Times Article, *Pfizer Proposes a Marriage and a Move to Britain, Easing Taxes,* April 29, 2014. The United Kingdom has sought out both headquarters companies and IP companies by lowering their corporate tax rate, easing their CFC rules, and adopting a patent box regime.

**Scope Issues**

While we believe finalizing this paper is premature given that the interaction with other items may significantly curtail the need for hybrid rules, we provide the following comments on scope.

The OECD should use the "bottom-up" approach which is significantly narrower than the "top-down approach". We reiterate our comment on the need to define related parties more narrowly, using a 50% threshold.

The proposed rules on imported mismatches should be removed. The BIAC comment letter sets forth in detail the problems that would be created by adoption of the imported mismatch rule. USCIB would like to emphasize two points: complexity and the extra-territorial reach. These very complex rules reach the peak of complexity in the context of imported mismatches. If a non-hybrid payment out of a jurisdiction is arm's length, does not violate thin capitalization rules, and has only received treaty benefits under an appropriate LOB provision, then that should be the end of the matter as far as that jurisdiction is concerned. To provide otherwise is to let a third country undo the policy choices of other sovereign countries. This is inappropriate.

The OECD is also interested in standards that can be used to identify structured transactions that ought to be subject to the rules. USCIB would like to identify two sets of rules that might serve as a model for identifying structured transactions. The US has adopted rules for identifying such transactions under section 6011, concerning tax shelter disclosure, and 901, concerning foreign tax credit generators. Either of these could serve as a model for the OECD.

Sincerely,

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UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

April 29, 2014

VIA EMAIL

Mr. Pascal Saint-Amans
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**Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)**

Dear Mr. Saint-Amans,

USCIB is pleased to have an opportunity to respond to the OECD's Discussion Draft on treaty issues involving hybrid mismatch arrangements.

The Discussion Draft would replace Article 1 with a new Article. Paragraph 1 of that new Article retains language saying the Convention applies to persons who are residents of one or both of the Contracting States. This seems inconsistent with new provisions intended to either resolve cases of dual residence or carve them out to the treaty.

The second paragraph states:

> [I]ncome derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. [In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State's right to tax the residents of that State.]

First, USCIB supports the inclusion of the so-called "saving clause". Including a saving clause may significantly reduce concern about inappropriate use of treaties by residents of one of the Contracting State and therefore require fewer anti-abuse rules in other contexts.

Second, USCIB believes this rule is not really an anti-hybrid rule at all, because the characterization of the entity in the source State should be irrelevant to the application of the rule. The basic issue is whether a source State should be giving a treaty benefit to a resident of the other state. The answer to this should be determined based on the shared expectations of the treaty partners. The recent Discussion Draft on Treaty Abuse makes this point quite clearly:

> Most of the provisions of tax treaties seek to alleviate double taxation by allocating taxing rights between the two States and it is assumed that where a State accepts treaty

provisions that restrict its right to tax elements of income**, it generally does so on the understanding that these elements of income are taxable in the other State**.[1]

This language basically expresses the shared expectations of the treaty partners. That is, the source State will give up taxing rights when income is subject to tax in the residence State as the income of a resident. The only way to determine whether the residence State will tax someone as a resident of that State is to apply **its** rules including its rules on transparency and opacity. So, the inquiry should be does the residence State see the income (for tax purposes) in the hands of a resident? If it does then source State should grant benefits. If not, the source State should not grant benefits. We believe there has been confusion on this point because of the general rule of treaty interpretation that one applies the laws of the source State unless the context otherwise requires. It seems without doubt that in a case in which whether the income of a resident is subject to tax in the State of residence is an issue where the context requires that the laws of the state of residence must apply both to determine the type of entity that is being characterized (transparent or opaque) and whether that entity is a resident.

To illustrate this we use three examples below. All of the examples assume a treaty identical to the OECD Model between State A and State B. There is, therefore, a 10% rate of withholding on interest in lieu of the statutory 30% rate in State A.

Example 1. An entity resident in State A pays interest of 100 to a State B entity (Company) that is fiscally transparent under the laws of State B. Company is owned 60%[2] by qualified residents of State B that are not themselves fiscally transparent under State B law. The other 40% of Company is owned by persons that would not be entitled to benefits under a treaty with State A. In this case the State of residence (State B) treats the recipient of the income as fiscally transparent and therefore State B will consider that 60 of interest income is earned by residents of State B and will expect State A to provide the negotiated rate on interest income with respect to that income. State A should therefore collect 6 of tax from the State B residents and 12 of tax from the non State B residents. It is irrelevant for this purpose whether Company is treated as an entity which is not a resident of State B (which would be what Company is if State A treats it as opaque) or looking through to non-resident owners.

Example 2: An entity resident in State A pays interest of 100 to a State B entity (Company) that is treated as an entity under the laws of State B. Company is owned 60% by qualified residents of State B. The other 40% of Company is owned by persons that would not be entitled to benefits under a treaty with State A. Despite the split ownership Company satisfies the ownership/base erosion test of the applicable LOB article. In this case, because State B treats the Company as the taxable recipient of the income, State B will consider that all of the interest income to be earned by a resident of State B and will expect State A to provide the negotiated rate on interest income with respect 100% of that income. Further, State A should expect to

[1] OECD Discussion Draft, BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, paragraph 81, revised Commentary paragraph 15.2. Emphasis added.

[2] We have changed this to 60% both because it is easier to follow the numbers if the division of income is not 50/50 and because we will be applying the limitation on benefits provisions is the next example.

grant this benefit, because Company is an entity that is a resident of State B (and therefore subject to tax in State B), and is a qualified resident of State B. Therefore, State A should collect 10 of tax on the 100 of interest. This would be true regardless of whether State A treats Company as fiscally transparent or opaque. This is because this is a LOB issue, not an issue of fiscal transparency. A corporation that is a qualified resident in State B is entitled to treaty benefits. If State A is concerned that too much of Company is owned by non-State B residents that is an issue for the LOB provisions, not these rules. This should be clear because in a case in which both State A and State B consider the entity to be opaque, State A should have precisely the same concerns. An example along these lines concluding that treaty benefits are available on 100% of the income ought to be included in the revised Commentary.

Example 3: An entity resident in State A pays interest of 100 to a State B entity (Company) that is treated as an entity under the laws of State B. Company is owned 60% by qualified residents of State B. The other 40% of Company is owned by residents of State A. Despite the ownership by State A residents Company satisfies the ownership/base erosion test of the applicable LOB article. In this case, because State B treats the Company as the taxable recipient of the income, State B will consider that all of the interest income to be earned by residents of State B and will expect State A to provide the negotiated rate on interest income with respect 100% of that income. Thus, State A would be entitled to collect 10 of tax on this income. This would be true regardless of whether State A treats Company as fiscally transparent or opaque.

The treatment of Company as a qualified resident of State B and entitled to treaty benefits does not answer the question how State A should tax the State A residents. If State A treats Company as opaque, then residents of State A will only be taxable under domestic CFC or PFIC type rules. This is not a treaty issue. It is the same result that would occur if Company were an opaque entity resident in a non-treaty jurisdiction. The opaque entity in a non-treaty jurisdiction would pay 30 of State A withholding tax. The reduction of tax on a payment to an entity that is treated as opaque in its country of residence is an LOB issue and granting a benefit to an opaque entity that is a qualified resident under a tax treaty is consistent with the shared expectations of the treaty partners.

If State A treats Company as fiscally transparent (regardless of what State B does), then in a treaty with a saving clause, State A clearly has the ability to tax its residents as if the treaty had no effect. In that case, State A will tax its residents at the rates applicable to domestic residents. Forty percent of the interest income and State A tax of 4 should be allocable to the State A residents under appropriate partnership/fiscally transparent accounting rules, such that the State A tax (like any other tax incurred by Company) would flow-through to the State A resident and offset the State A tax ultimately due[3]. We believe this should be the result even in the case of a treaty without a saving clause, but it is certainly clear if there is a saving clause.

We recommend including an example along these lines in the Commentary to Article 1.

[3] This is not a foreign tax credit. State A would be giving a credit for State A tax paid to a resident of State A, so it is essentially a pre-payment of State A tax. This is simply the flow-through of a State A tax paid at the entity level to a State A partner/owner of a partnership/fiscally transparent entity.

Paragraph 26.6 of the Discussion Draft contains some language that USCIB believes is problematic.

> [I]f an entity is established in a jurisdiction from which a Contracting State cannot obtain tax information, that State would need to be provided with all the necessary information in order to be able to grant the benefits of the Convention. In such a case, the Contracting State might well decide to use the refund mechanism for the purposes of applying the benefits of the Convention even though it normally applies these benefits at the time of the payment of the relevant income.

USCIB is very concerned with this language because of its possible implications for investors, particularly portfolio investors. Delays, or possible denial of treaty benefits, may have a significant impact on cross-border investment. Business has been working with the OECD on the TRACE project to create a uniform system for granting benefits at source. Countries should be encouraged to engage in this process. TRACE stands for Treaty Relief and Compliance Enhancement. This is important because these concepts go together; granting treaty relief in appropriate cases at source will also enhance compliance. We believe that the OECD may be missing an opportunity to combine the work on AEOI based on the FATCA rules with the TRACE effort. If this opportunity is missed, we are concerned that countries and financial institutions will be reluctant to go back and modify systems to incorporate the treaty relief components of TRACE. We urge you to de-emphasize refund systems and work to incorporate appropriate treaty relief mechanisms in the ongoing AEOI work.

Comments on the Credit Method of Relieving Double Taxation

USCIB is concerned about the following statement in paragraph 22:

> [D]ouble non-taxation situations may arise in the application of the credit method…One example would be domestic law provisions that allow the foreign tax credit applicable to one item of income to be used against the State of residence's tax payable on another item of income. This is another situation where Contracting States should ensure that their tax treaties provide for the elimination of double taxation without creating opportunities for tax avoidance strategies.

The BEPS Action Plan recognizes that "taxation is at the core of countries sovereignty" and that countries have the right to establish their own tax rules.[4] Thus, countries may choose to relieve double taxation through an exemption/territorial system or a foreign tax credit system. Either of these choices is appropriate. A foreign tax credit system is a more precise method of relieving double taxation and will generally result in less untaxed income. Countries that have a foreign tax credit system need to balance the potential for cross-crediting with the administrative burden imposed by very restrictive foreign tax credit rules. If countries have a sovereign right to choose an exemption/ territorial system, then they may also appropriately choose a world-wide credit even though that might permit some cross-crediting of taxes from a

[4] OECD BEPS Action Plan, page 9.

high-tax jurisdiction against income earned in a low-tax jurisdiction.[5] There are a range of reasonable choices from which sovereign countries may choose to eliminate double taxation and they do not need to choose the narrowest option. USCIB is concerned that the Discussion Draft implies a treaty obligation to limit the foreign tax credit, so that the residence country would be required to collect tax to the extent that source country tax is relieved[6]. Tax treaties do not operate so precisely. The key issue is whether the income is subject to tax in the hands of a resident of the State of residence. Many residence State rules may result in the reduction or elimination of residence State tax. For example, if the company receiving the income has an operating loss, there may be no tax due. Foreign tax credit rules that permit cross-crediting are a reasonable approach and should not be precluded by overly restrictive treaty rules.

Sincerely,

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[5] Indeed, the benefit of this cross-crediting really accrues to the other high-tax jurisdiction because it makes it less costly to invest in a high-tax jurisdiction if cross-crediting is permitted.
[6] US law generally creates a separate "basket" for income that is treated as foreign source under the treaty, but does not otherwise separately "basket" income that is foreign source without regard to the treaty.

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