

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,
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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.

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,

A handwritten signature in black ink that reads "Will Morris". The signature is written in a cursive, slightly slanted style.

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 of 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.

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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

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- 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.

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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);

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- 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 unintended 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.

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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.

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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.

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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, BIAAC 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.” BIAAC 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. BIAAC 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).

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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 disincentivise 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, BIAAC 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 BIAAC 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. BIAAC 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. BIAAC 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.

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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 countries 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.