William Morris
Chair, BIAC Tax Committee
Business & Industry Advisory Committee
13/15, Chauseee de la Muette
75016 Paris
France

Kate Ramm
Senior Advisor to the BEPS Project
Centre for Tax Policy and Administration

John Peterson
Senior Advisor – ATP
Centre for Tax Policy and Administration

Organisation for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris
Cedex 16
France

Submitted by email: kate.ramm@OECD.org; john.peterson@OECD.org

Friday, 21 October 2014

Ref: Further consultation on hybrids

Dear Kate and John,

Thank you for your letter dated 22 October 2014, and the opportunity to provide further comments in relation to Action 2 of the BEPS Action Plan.

In your letter, you requested input from BIAC Tax Committee members that could assist you in developing the necessary commentary to explain the application of the recommendations in your Hybrids Report. In particular, you noted that the following would be useful to provide:

i) examples where the hybrid mismatch rules may be difficult to apply, or where their application is not clear; and

ii) examples of the problems that could arise in applying the proposed rules to intra-group mismatches to assist you in developing solutions, focusing on:

   a. Hybrid financial instruments (in relation to on-market trading activities); and

   b. Imported mismatches (in relation to controlled groups).

I have shared your request with the BIAC Tax Committee and have received a number of responses. These responses have been appended to this letter.

Please note that this letter represents a collation of information provided by individual BIAC members, and does not represent a consensus position of the BIAC Tax Committee.

BIAC THE VOICE OF BUSINESS AT THE OECD

I have set out below a summary of the appended documents, and some additional comments for you to consider.

Appendix A: BASF Letter

BASF has prepared a set of three examples with respect to where mismatches arise from hybrid financial instruments, with the intention of illustrating where guidance will be required to effectively implement the OECD's proposals. Based on those examples, BASF has identified a number of specific concerns for you to consider.

Appendix B: CBI Scenarios

The Confederation of British Industry (CBI) has developed a number of scenarios where specific examples in the OECD's commentary would be particularly helpful, identifying specific questions for you to consider.

Appendix C: CBI Imported Mismatches

The CBI has developed an example where a multinational group establishes a Treasury Centre to manage all of its cash and funding requirements. It was then considered how the OECD's proposals would apply to the example and what challenges might arise.

The letter explains the anticipated difficulties that countries will face in trying to agree the very complex and formulaic rules that would be required to determine and allocate taxing rights under the proposed imported mismatch rules. Based on such difficulties, the CBI believes the compliance cost and burden associated with the application of such rules would be disproportionate.

Based on the challenges identified, an alternative proposal was suggested using a purpose based test.

Additional Contribution from the Financial Services Sector

Impact on intercompany stock lending and repo transactions

Several members of the ABI, AFME, BBA, CBI, ICMA and ISLA[1] are in the process of preparing a document that intends to provide a high level overview of how repo and stock lending transactions work, and to outline their concerns regarding the application of Action Item 2 to the operation of the capital markets. The group is currently working on a proposal as to how such concerns might be addressed in a manner which takes into account feedback received from previous OECD Working Group meetings. The group intends to share its letter with you in the coming weeks.

Other Comments

Hybrid Financial Instruments

In BIAC's previous submissions, we had recommended that the definition of a 'hybrid transfer' for the purposes of the proposed rules be limited, consistent with the definition of hybrid instrument. Specifically, we believe that the proposed rules generally should 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

[1] Association of British Insurers (ABI), Association for Financial Markets in Europe (AFME), British Bankers' Association (BBA), CBI and International Capital Market Association (ICMA) and the International Securities Lending Association (ISLA)

transaction. This should have the effect of carving out ordinary-course repo and stock lending transactions.

Matching Treatment

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 clearly set out their tax treatment of particular instruments, e.g. Tier 2 debt instrument issued under Solvency 1, so both tax-payers and tax authorities can directly identify the appropriate tax treatment for both lender and borrower.

In your letter you mentioned that you would like to arrange a meeting with some BIAC tax committee members, and we would of course be happy to do this. We will follow up separately to find a date.

I hope that you find this information useful and please do not hesitate to contact me if you have any questions.

Sincerely,

Will Morris

Will Morris
Chair, BIAC Tax Committee

BIAC THE VOICE OF BUSINESS AT THE OECD

Appendix A: BASF Letter

BASF
The Chemical Company

BASF SE, 67056 Ludwigshafen, Germany

Via email

Peter Marrs
Peter.Marrs@ge.com

Will Morris
William.Morris@ge.com

November 13, 2014
Alexander Just
ZRS – D 100
Phone +49 621 60-43544
Fax +49 621 60-21697
alexander.just@basf.com

BEPS Action 2 – Requesting for Inputs on Hybrids
Your email dated November 3, 2014

Dear Peter,
Dear Will,

We refer to the aforementioned email and appreciate the opportunity to provide examples where the OECD hybrid mismatch rules may be difficult to apply or where their application is not clear.
Generally, we support the OECD BEPS initiative with the intended goal to avoid abusive double non-taxation. However, the hybrid mismatch rules seem to approach intra-group financing instruments in an isolated manner on a transactional basis ignoring the broader picture of the overall economic background of a financing structure and therefore could lead to a double or multiple taxation as well as more uncertainty for tax payers.

If the OECD considers linking rules as an appropriate measure to avoid abusive double non-taxation it should also allow tax payers an escape in cases that should not be considered inappropriate from an economic perspective, because they actually do not trigger a double non-taxation.

Please find enclosed 3 examples with respect to mismatches arising from hybrid financial instruments (deduction and no inclusion, 'DNI') showing potential results from the OECD linking rules without a clear guidance on their applicability.

Please find the following summary of major concerns supported by the attached simplified examples:

1. **OECD primary rule vs. rule according to the EU Parent Subsidiary Directive ('PSD')**
   - The OECD primary rule denies the payer deduction while the defensive rule stipulates an inclusion as ordinary income by the recipient.
   - However, the revised PSD only applies an inclusion as ordinary income by the recipient.
   - Currently, there seems to be no order of precedence between the OECD and the PSD rules.
   - This contrary approach could in practice lead to a double taxation (see example 1).

- The OECD as well as the PSD both provide guidance on local tax treatment and therefore a potential double taxation resulting from the linking rules could not be solved by a mutual agreement procedure.

2. Interaction with local interest deductibility rules

- The OECD rules are applicable for intragroup structures without considering the overall economic background.
- This could result in a double taxation if the recipient in a hybrid structure suffers non- deductible refinancing costs, e.g. due to a link to tax exempt dividend income, based on interest capping rules or thin capitalization rules.
- Therefore it is crucial to exclude such cases from the OECD hybrid mismatch rules or allow an escape for the taxpayer (see example 2).

3. Withholding tax implications

- The OECD linking rules could trigger double taxation if a denial of deduction at the payer's level does not automatically trigger a mitigation of withholding tax on the underlying payment. (Article 11 of the OECD Model Convention; see example 3).

4. Definition of "deductible" / "nondeductible"

- The OECD commentary should in our view also include guidelines / definitions when exactly a payment under a hybrid instrument is considered deductible / non-deductible, e.g. in cases where the deductibility may be deferred due to an interest carried forward that could be used in future years or in cases where the interest deductibility is limited to a certain ratio without any carry forward by domestic law.

5. Interaction with other BEPS measures

- The commentary should also include the interaction between Action 2 and other BEPS Actions, in particular Action 4 'Limit base erosion via interest deduction and other financial payments' and should provide guidance on the hierarchy of the different measures.

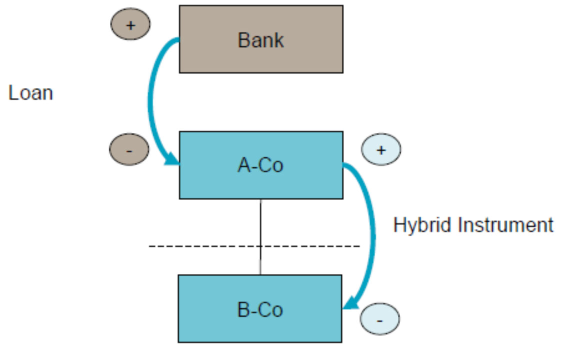
We hope that our comments are useful. Please feel free to contact us with any questions you may have on the above.

Yours sincerely, BASF SE

Encl.

BASF The Chemical Company

Base Case



Circumstances

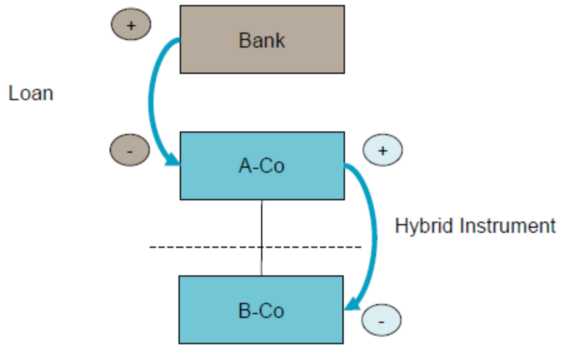
- Interest on bank loan to A-Co is fully tax deductible.
- Hybrid instrument is considered equity in country A. A applies participation exemption on income.
- Hybrid instrument is considered debt in country B. Interest is fully tax deductible.
- Tax rate A = tax rate B = 30%.

Economic effect / tax impact

- Harmful double non-taxation under the OECD BEPS initiative.
- OECD hybrid mismatch rules aim at a single tax benefit on interest expense in the amount of 30.

	Income	Tax	
		Today	Goal
A-Co	100	0	?
	-100	-30	?
Subtotal	0	-30	?
B-Co	-100	-30	?
Total	-100	-60	-30

Example 1 OECD vs. EU Parent Subsidiary Directive



Circumstances

- See base case.

Domestic application of hybrid mismatch rules

- Country B applies the OECD primary rule and denies the deduction at B-Co.
- Country A applies the EU PSD approach and includes the payment in A-Co's ordinary income.

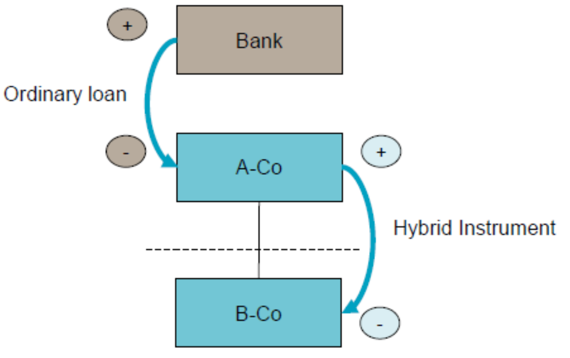
Economic effect / tax impact

	Income	Tax			
		Today	OECD	PSD	OECD+PSD
A-Co	100	0	0	30	30
	-100	-30	-30	-30	-30
Subtotal	0	-30	-30	0	0
B-Co	-100	-30	0	-30	0
Total	-100	-60	-30	-30	0

- Specific order of precedence for OECD primary rule and PSD?

BASF
The Chemical Company

Example 2 Tax treatment of refinancing costs



Circumstances

- See base case.
- However, interest expense on bank loan is not deductible in country A (e.g. due to participation exemption rules, interest capping rules or thin capitalization rules).

Domestic application of hybrid mismatch rules

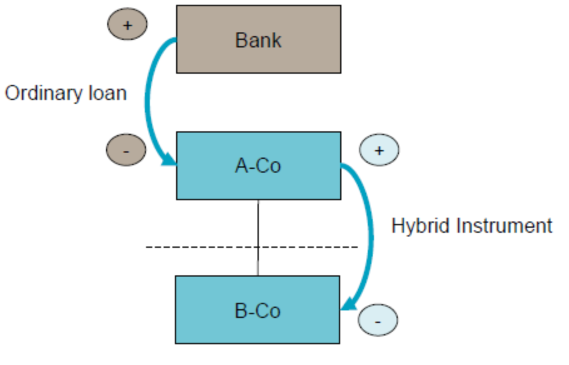
- See example 1.
- Interest expenses at A-Co remain nondeductible.

Economic effect / tax impact

	Income	Tax			
		Today	OECD	PSD	OECD+PSD
A-Co	100	0	0	30	30
	-100	0	0	0	0
Subtotal	0	0	0	30	30
B-Co	-100	-30	0	-30	0
Total	-100	-30	0	0	30

- Escape clause?

Example 3 Withholding tax



Circumstances

- See base case.
- Interest payment from B-Co to A-Co is subject to 15% withholding tax (WHT) in country B.
- Due to participation exemption no WHT credit at A-Co.

Domestic application of hybrid mismatch rules

- See example 1.
- Nondeductible interest is still subject to WHT in country B.
- No WHT credit at A-Co due to participation exemption or due to a lack of tax base respectively.

Economic effect / tax impact

	Income	Tax			
		Today	OECD	PSD	OECD+PSD
A-Co	100	0	0	30	30
	-100	-30	-30	-30	-30
Subtotal	0	-30	-30	0	0
B-Co	-100	-30	0	-30	0
WHT		15	15	15	15
Total	-100	-45	-15	-15	15

Appendix B: CBI Scenarios

CBI, Cannon Place
78 Cannon Street
London EC4N 6HN

THE VOICE OF BUSINESS

17 November 2014

CBI Issues to be addressed in the detailed guidance notes to supplement the OECD Report on Neutralising the Effects of Hybrid Mismatch Arrangements.

Imported Mismatches

A separate paper has been prepared and discussed with the UK representatives of the OECD working group outlining our key concern regarding the operation of the imported mismatch rules where we would be grateful for further guidance.

Repo and Stock Lending

A separate joint paper is being prepared by all UK Financial Services industry bodies which will provide more information regarding the Repo and Stock Lending market and ways to address the compliance burden. This should be ready in the forthcoming weeks. This paper has been developed through discussions with the UK representatives of the OECD working group.

The paper also sets out some concerns about the definition of “structured transactions” and how they apply to repo’s and stock lending which we would be grateful could be addressed in the guidance.

Ordinary Income

Please can there be specific examples which outline the treatment in respect of the following situations:

a) Different types of tax within a jurisdiction

Example: A UK Company undertakes a financial transaction with a US LLC – the US LLC is transparent for US tax purposes and therefore the individual owners are subject to tax on the income. However, under US tax law, the income from the transaction is taxed on the US individuals as a long term capital gain at 15% rather than the full federal rate of 35%.

Would the above US recipients be considered as receiving “ordinary income”? If not, please explain how double taxation would be addressed if the full deduction is denied but the income remains subject to 15% tax?

b) Payments to tax incentive companies

Similar to a) the above – but a UK company undertakes a financial transaction with a Singapore affiliate. Due to tax incentives in Singapore, such financial transactions are taxed at 10% rather than the full statutory rate of 17%.

Would the above Singapore recipients be considered as receiving “ordinary income”? If not, please explain how double taxation would be addressed if the full deduction is denied but the income remains subject to 10% tax?

c) Payments to tax havens

Please provide an example of a simple financial transaction between say a UK company and a tax haven company – the latter not being subject to tax on any of its income. It should be clear that this should not fall within the rules as the non-payment of tax has nothing to do with hybridity (para 47) and therefore should be included as “ordinary income” for the recipient in the tax haven. This should be made explicitly clear in an example.

d) Income earned by a foreign PE

Please provide an example of income on a financial instrument from a related party which is received by a foreign permanent establishment of a company. The territory of residence operates a PE exemption system so the income is exempt from tax in the territory of residence. However, the income is subject to tax at the full marginal rate of tax in the territory of the PE (which lets assume is a lower rate than the territory of residence). Please provide a specific example outlining this scenario in the guidance notes to the hybrid rule confirming that in this instance, the full marginal rate of tax should be measured by reference to either the territory of residence or the territory of the permanent establishment (otherwise there will be a major issue in the banking sector who for regulatory reasons often trade through branches in foreign countries and therefore often have transactions between related parties where the income would be subject to tax at only the full rate in the branch which may be both higher and lower compared to the rate in the territory of residence).

e) Tax losses

Please provide an example of a simple financial transaction between two related companies where the person receiving the income is able to offset that income against tax losses (either brought forward, current year, or losses received from another company under a tax consolidation scheme). Please confirm in an example that the offset of losses by the company should not be considered a “credit” or “other tax relief” for the purposes of defining ordinary income.

f) Insurance Profits

Some profits and gains of a particular class of insurance business are exempt from tax. 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, a requirement to identify the relevant instruments and the “ordinary income” would place a significant, disproportionate and unnecessary compliance burden on life insurers. Therefore, for the avoidance of doubt the commentary should say that there is 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.

g) Timing Differences

We note in your paper (Recommendation 1 para 1(c)), that timing differences should not give rise to a D/NI outcome for a payment under a financial instrument provided it will be included as ordinary income within a reasonable period of time.

So please provide an example of say a discounted note with a term of X years. The borrower gets financing deductions on an accruals basis throughout the life of the instrument. However, the lender only gets tax on the realisation of the note in year X when the actual funds are received. Please confirm how many years X can be before the rules apply. Also, say X is (purely for illustrative purposes) 5 years and the note is 10 years. Would this mean that for the first 5 years, no deduction would be available as the lender is not taxed within a reasonable timeframe – but for the latter 5 years, a deduction could be claimed as the taxation point for the lender is then within a reasonable time period.

Please also confirm how double taxation is to be avoided in cases where a deduction is denied due to the length of time between the deduction and the income being taxed? – Can the borrower claim a subsequent deduction for all amounts disallowed in the period the income is taxed on the lender, or should the recipient not be subject to tax on the income? (The former would make most sense).

Related Persons

a) Regulatory Capital

- Insurers will often not be able to easily identify (if at all) holders of the externally issued Regulatory Hybrid Capital because it is often held through custodian etc. accounts – this point is acknowledged in the OECD Hybrids Discussion Draft.
- Life insurers receive substantial premiums from policyholders which they invest to support policyholder liabilities. As a result portfolio holdings of a life insurer will be greater than those held in other sectors.
- Some of the investments to support policyholder liabilities are made in funds (who may also invest in other funds).
- Insurers undertake stock loans and repos.

An insurer should, for non-tax reasons, know whether the 25% related party limit for holders of its regulatory hybrid capital has been breached. As such insurers should not, apart from exceptional circumstances, be made to demonstrate on a holding by holding basis that the 25% related party limited has not been breached since this would be a significant and disproportionate compliance. In other words there should be a presumption that, unless there was evidence to the contrary, external issues Regulatory Hybrid Capital are not held by related parties.

Limiting tax transparency for reverse hybrids controlled by non-resident investors

a) Multiple investors in different jurisdictions.

Paras 89 and 90 of the OECD report outline situations where a reverse hybrid should be treated as tax resident in the intermediary jurisdiction. Please provide details further details of when this should potentially apply using an example as follows:

A partnership is set up in Country A which treats the partnership as transparent. There are 100 partners which are resident in Country B and Country C (the mix between each country will change each year). In Country B, the partnership is seen as transparent, and in Country C the partnership is seen as a company. Due to the type of income received, Country A does not tax the income.

Please answer the following questions:

- Is there a threshold as to the amount of the partnership that is held by "hybrid" owners before the rules apply? For example would 1 partner in Country C (owning just 1% of the partnership) be enough for the rules to apply even though 99% of the partnership income is subject to tax on the partners in the current year?
- Would both Country B and C have to respect the change such that the partnership is treated as a company in all 3 jurisdictions?
- If Just Country A is required to treat it as a company (such that Country B still treats it as transparent), please provide details as to how double tax relief should work such that the profits are taxed just once (and not in both A & B).

Appendix C: CBI Imported Mismatches

Imported Hybrid Mismatches – Treasury Centre Example:

The multinational group headed by A Co (the **Group**) has an established Treasury Centre[2] managing all of its cash and funding. The Treasury Centre has the staff, resources and expertise necessary to provide the same sort of services to the Group on the same terms as may be obtained from outside financial institutions, but with the economies to the Group afforded by having such services "in house".

The Treasury Centre is tax resident in a jurisdiction that may or may not be the same as one of the other Group operating entities identified in the diagram below (A to G Co). The Treasury Centre was located in its particular jurisdiction for commercial reasons and its attractive tax profile (proximity to market, time zone, well established legal/accounting systems, low political risk, language, availability of appropriately skilled employees). The Treasury Centre location has a low statutory tax rate and a wide network of treaties, adding to its commercial attractiveness.

The Treasury Centre's activities include the management of the Group's cash and funding requirements using a variety of financial products (of different terms, securities and currencies etc.) All debit and credit financial transactions between the Treasury Centre and related party entities are established and priced in accordance with the Arm's Length Principle.

The Group raises all medium/long-term capital in various jurisdictions in the most efficient way possible. Excess funds raised by Group operating companies are contributed to the Treasury Centre. Providers of funds are compensated on an arm's length basis for such funding.

The Treasury Centre maintains its interest rate and foreign exchange exposures through a variety of hedging transactions, either directly with third party banks, or with a centralised affiliated hedging company.

The diagram below illustrates a typical situation in the Group. Each company in the diagram is resident in a different jurisdiction (A Co is resident in Country A, B Co is resident in Country B, and so on)

Considering the OECD's hybrid mismatch (financial instrument) proposals, this example assumes the following:

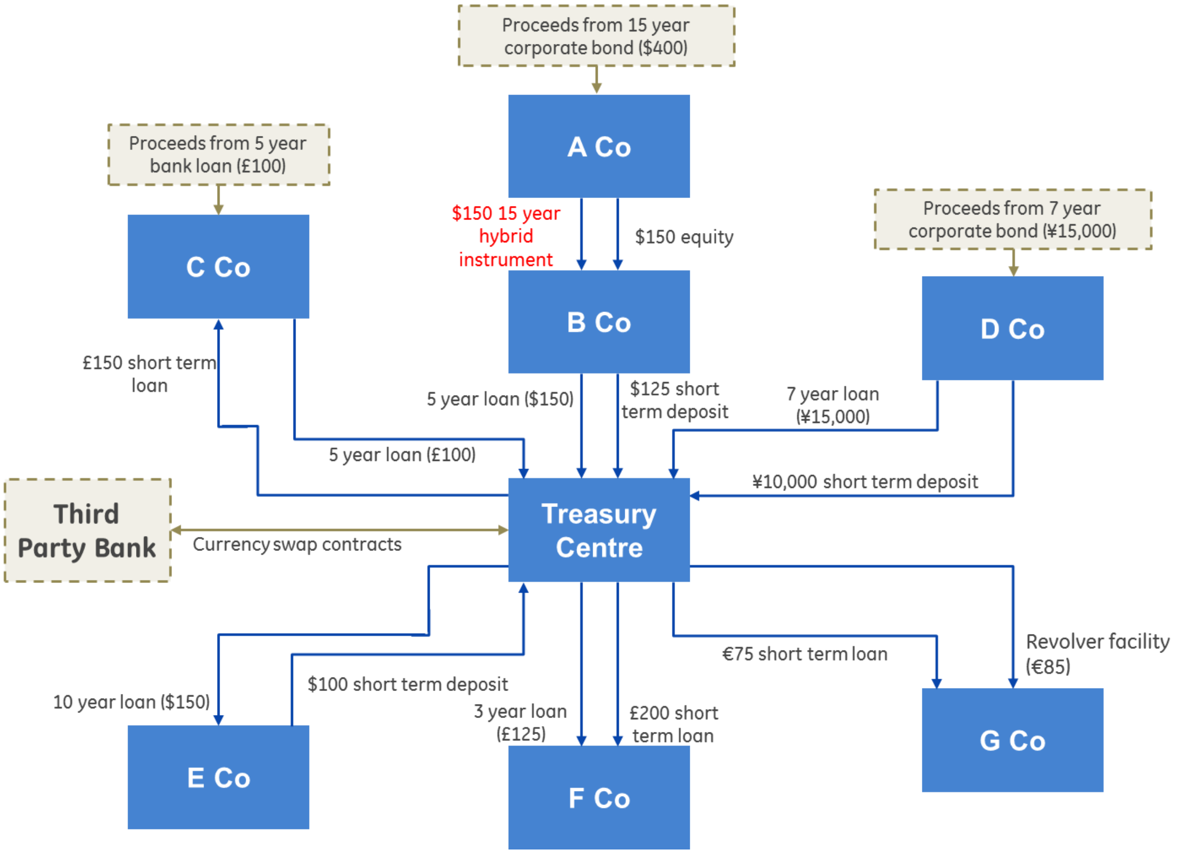
1. B Co is funded through equity and a long term hybrid financial instrument from A Co. B Co is permitted a deduction for the interest expense associated with the hybrid instrument, but A Co is not taxed on the corresponding income.

2. Country B has not implemented the OECD's primary rule to deny the interest deduction and Country A has not implemented the OECD's secondary rule for the income to be taxed.

---

[2] A similar fact patter could equally apply to a centralised IP management (and ownership) company or a centralised provider of management services.

This example considers the matters Countries C, D, E, F and G (and the Treasury Centre jurisdiction) would have to consider if they wished to implement the OECD's proposed imported mismatches rule where the ultimate payor jurisdiction is required to deny the deduction.



Questions for discussion:

- Which Countries would be entitled to implement the OECD's imported mismatch rule to deny a deduction (C, D, E, F, G and/or the Treasury Centre jurisdiction)?
- If only one Country is permitted to deny a deduction, how is the proportion of the disallowed deduction determined (taking account potential differences in interest rate, term, security, currency and volume of the transactions etc.)?
- If more than one Country is permitted to deny a deduction, how is the proportion of the disallowed deduction determined and shared between the Countries (taking account potential differences in interest rate, term, security, currency and volume of the transactions etc.)?
- Where a calculation method is agreed to by tax authorities, what practical implementation issues would MNEs face? *[Calculation methods to determine such an allocation would have to take into account the differing terms of all of the relevant financial transactions (interest rate, term, security, currency and volume etc.) and how those transactions might change over time.]* Would it be possible to trace all group transactions in an effective way to monitor and manage disallowances determined by such a calculation method?
- Would the outcome be different if there was no related party hybrid funding, but the Treasury Centre was partially funded by a third party bank that raised capital using hybrid instruments?

Proposal

- We believe it will likely be impossible for countries to agree to the very complex and formulaic rules that would be required to determine and allocate taxing rights under the proposed imported mismatch rules, and that the compliance cost and burden associated with the application of such rules would be disproportionate. With that in mind, we would be happy to work with you to develop your proposals using objective tests/hallmarks where possible to facilitate practical implementation.