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 dis-proportionate. 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 Thin Cap Group Litigation, § 83 *et seq.*; Case C- 282/12 Itelcar, § 34 *et seq.*). 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
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.

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?	

(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.

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.