O.E.C.D. TARGETS HYBRID MISMATCH ARRANGEMENTS USING BRANCH STRUCTURES

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Recently, the O.E.C.D. released draft recommendations[1] for domestic law that would neutralize income inclusion mismatches that can occur between payor and payee countries when using a branch structure ("Discussion Draft"). Mismatch arrangements were analyzed in the B.E.P.S. (Base Erosion and Profit Shifting) Action 2 report ("Action 2 Report") that was released in October of last year.[2] According to the O.E.C.D., an amendment to reflect branch rules was needed because the hybrid recommendations outlined in the Action 2 Report did not adequately address mismatches resulting from branch structures.

The recommendations seek to resolve issues where

- a payment is deductible in one country, but not included in another (deduction/no inclusion ("D/NI") outcome);
- a single payment triggers a deduction in both countries (double deduction ("DD") outcome); or
- a deductible payment is set off, by the payee, against income that is not included in the payor and payee countries (indirect deduction/no inclusion ("indirect D/NI") outcome).[3]

The recommendations highlight five situations where a mismatch in a branch scenario is deemed to occur because the residence and branch jurisdictions (*i.e.*, the jurisdictions in which the payor and branch are located – herein the "Residence Jurisdiction" and the "Branch Jurisdiction") take differing views as to the status of the branch. Note that the payment need not be made from a head office to the branch. The only item that matters is how the Residence Jurisdiction and the Branch Jurisdiction differ in their views of the tax status of the branch. The Branch Jurisdiction does not treat the taxpayer as having a taxable presence in that jurisdiction so that income of the branch is not taxed. In comparison, the Residence Jurisdiction recognizes the branch as if it were a separate entity so that the income of the branch is not included in the income of the head office.

DISREGARDED BRANCH STRUCTURE

In the first structure targeted by the Discussion Draft, A Co (a resident of Country

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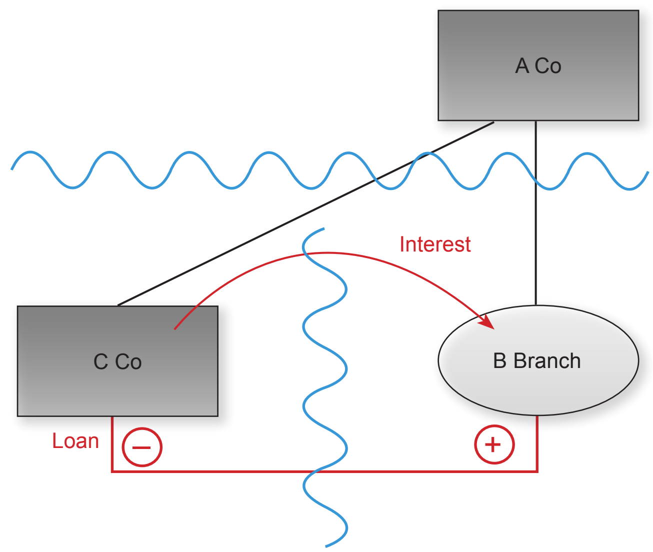
1. O.E.C.D., *Public Discussion Draft on B.E.P.S. Action 2 Branch Mismatch Structures*, (Paris: O.E.C.D. Publishing, 2016).
2. Stanley C. Ruchelman, "O.E.C.D. Discussion Drafts Issued Regarding B.E.P.S. Action 2 – Neutralizing Hybrid Mismatch Arrangements," special issue, *Insights* B.E.P.S. Retrospective (2014).
3. See 6, of the Introduction to Part I of the Action 2 Report.

A) owns C Co (a resident of Country C) and B Branch (a branch located in Country B). A Co arranges for a loan to C Co, under terms that involve payments of interest and principal to B Branch. The payment is treated as a deduction for income tax purposes in Country C. Country A (*i.e.*, the Residence Jurisdiction) treats the interest as having been received by a foreign branch that is exempt from tax in Country A, either by reason of a treaty or domestic law. Country B treats B Branch as a representative office of A Co, not as a permanent establishment ("P.E."). Hence, no tax is imposed. Consequently, the payment of interest is deducted by C Co but is not taxed in the hands of A Co or B Branch.

"The mechanics and the resulting tax outcomes from the use of a disregarded branch structure are similar to those of a reverse hybrid."

Figure 1



The mechanics and the resulting tax outcomes from the use of a disregarded branch structure are similar to those of a reverse hybrid, discussed in Chapters 4 and 5 of the Action 2 Report, in that both the Residence Jurisdiction and the Branch Jurisdiction exempt or exclude the payment from income on the grounds that the payment should be treated as received (and therefore properly subject to tax) in the other jurisdiction.

The Discussion Draft explains the reasons for the D/NI result:

- The Residence Jurisdiction treats interest income as paid to a foreign branch and therefore tax exempt under its domestic law, whereas the Branch Jurisdiction does not tax this income absent a taxable presence in its territory under its domestic rules.
- The foreign branch constitutes a P.E. under the treaty between the two jurisdictions. The Residence Jurisdiction is thus required to exempt this income under treaty rules. However, under the domestic law of the Branch Jurisdiction, no taxable presence is created.[4]

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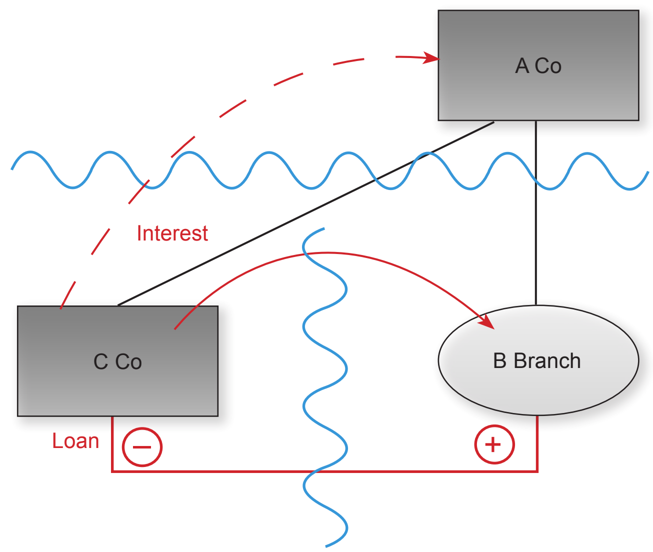
4 Note that an income tax treaty may only be applied to reduce or eliminate double taxation when income of a person may be taxable in two countries. However, it cannot create a right to taxation where under applicable domestic tax law no right to taxation is granted.

- The foreign branch does not qualify as a P.E. under the applicable treaty. Hence, the Branch Jurisdiction is not entitled to tax the branch's income, while the Residence Jurisdiction's domestic law exempts the payment as foreign branch income under its domestic rules.

DIVERTED BRANCH STRUCTURE

A diverted branch payment has the same structure and outcome as a payment to a disregarded branch except that the mismatch arises not because of conflict in the characterization of the branch but rather due to a difference in the way that payments to the branch are attributed under the laws of the Residence Jurisdiction and the Branch Jurisdiction. The structure is similar to Figure 1, above.

Figure 2



The mismatch arises because B Branch treats the interest payment as if it were paid directly to the head office in Country A, while the head office continues to treat the payment as having been made to B Branch. Consequently, the payment is not subject to tax in either jurisdiction (*i.e.*, a D/NI outcome) either because of different allocation methods applied in each country or an exclusion that is based on nonresident status of B Branch. Similar to the disregarded branch structure, the O.E.C.D. draws parallels to reverse hybrid structures discussed in the Action 2 Report in that the Residence and Branch Jurisdictions exempt or exclude payments from taxation because on a reciprocal basis the payment is construed as received in the other jurisdiction.

O.E.C.D. Recommendations

To resolve the diverted and disregarded branch mismatch problems, the draft recommends conformity of tax treatment at two levels. The first level is conformity between the Residence and Branch Jurisdictions. Under this approach, the Residence Jurisdiction should adjust its branch exemption rules to parallel the treatment in the Branch Jurisdiction. Thus, if the branch country exempts the income, the income would be taxed in the Residence Jurisdiction as if received in that jurisdiction.

Only when the Branch Jurisdiction taxes the income would an exemption be granted by the Residence Jurisdiction.

The second level recommends conformity between the jurisdiction where the payer is resident with the treatment in the Residence and Branch Jurisdictions. Where the mismatch is part of a structured product or where the parties are related, a deduction would be denied to the payer when a diverted branch payment or a disregarded branch payment is made and there is no inclusion in the Residence Jurisdiction nor in the Branch Jurisdiction. A person is considered to be a party to a structured payment when it has a sufficient level of involvement in the arrangement to understand how it has been structured and what its tax effects might be.

On the other hand, the O.E.C.D. acknowledges that abusive planning exists only where a taxpayer takes advantage of a mismatch in the attribution of profits in the Residence and Branch Jurisdictions. Consequently, in a case where the payment would have been excluded in the Residence Jurisdiction if the head office received the income directly, a deduction should be allowed to the payer in its country of residence. The example identified by the O.E.C.D. focuses on a head office of a tax-exempt entity in its country of residence.

Observations

The recommendation to prevent D/NI treatment is far-reaching and may be construed as introducing a subject-to-tax requirement for exemption of foreign branch payments in the Residence Jurisdiction. This would be infringing upon tax principles in countries with a territorial tax system, which limits taxation to only domestic income and exempts foreign income, subject to different treatment for controlled foreign corporations. This system is found in many European countries, including France, Spain, and the U.K., and also in Canada, Japan, and Australia.[5]

It should also be noted that, in the context of diverted payments, it would be less burdensome if no adjustments were required when the Residence Jurisdiction does not tax this type of income.

DEEMED BRANCH PAYMENT

While the recommendations on diverted or disregarded branch structures deal with third-party payments, a mismatch may also arise in cases where payments are made by the branch to its head office.

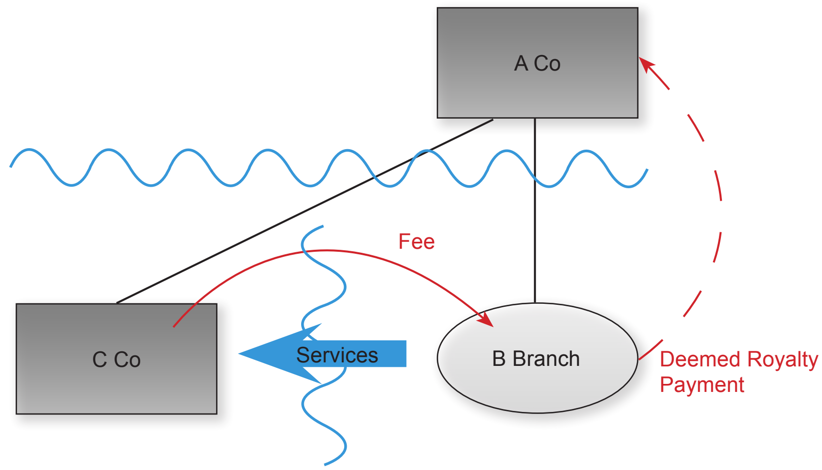
These mismatch arrangements are identified as deemed branch payments. The payments are recognized in the Branch Jurisdiction and thus treated as deductible. However, there is no income inclusion in the Residence Jurisdiction because the payment is deemed to be made internally (*i.e.*, within the same taxpayer) – treatment that is contrary to the separate entity approach mandated by the O.E.C.D. transfer pricing principles in branch scenarios.

To illustrate the mismatch, the Discussion Draft refers to a deemed royalty payment made by the branch located in Country B to its head office located in Country A.

5 While the U.S. is one of the few countries with a worldwide tax system, a change to the territorial system has been requested on various levels, including most recent initiatives.

The branch uses intangible property ("I.P.") owned by the head office in performing services for a related company based in Country C.

Figure 3



In attributing ownership of the I.P. to the head office, Country B recognizes the arm's length payment by the branch for the use of the I.P. and treats it as deductible. Country A does not recognize the royalty payment (because it attributes the ownership in the I.P. to the branch). The service income is exempted from tax in Country A under an exemption or exclusion for branch income that is available in Country A. To the extent the deduction is set off against the branch services income, the deemed payment results in an intra-group mismatch. The services income is neither taxed in Country B (because it is offset by the deemed royalty payment) nor in Country A (due to an exemption or exclusion rule). The O.E.C.D. calls this non-dual inclusion[6] income since the income is not taxed in either country.

"The Discussion Draft recommends the denial of a deduction, at the level of B Branch, for the deemed branch payment to the extent it exceeds dual inclusion income."

A variation of this example takes the mismatch one step further. The deduction could even result in a loss for the branch. This loss could then be used to offset income of another Country B group company under, for example, a group taxation regime. According to the O.E.C.D., this effect is not limited to royalty payments but may also apply to other deemed payments such as interest payments.

O.E.C.D. Recommendations

To remedy this mismatch, the Discussion Draft recommends the denial of a deduction, at the level of B Branch, for the deemed branch payment to the extent it exceeds dual inclusion income.[7] If this recommendation is not implemented into the Branch Jurisdiction's law, the O.E.C.D. proposes that the Residence Jurisdiction should treat the deemed payment as ordinary income to the extent necessary to eliminate the mismatch.

A payment that is treated for tax purposes as made between the branch and head office but which, in practice, represents an allocation of third-party expenses should

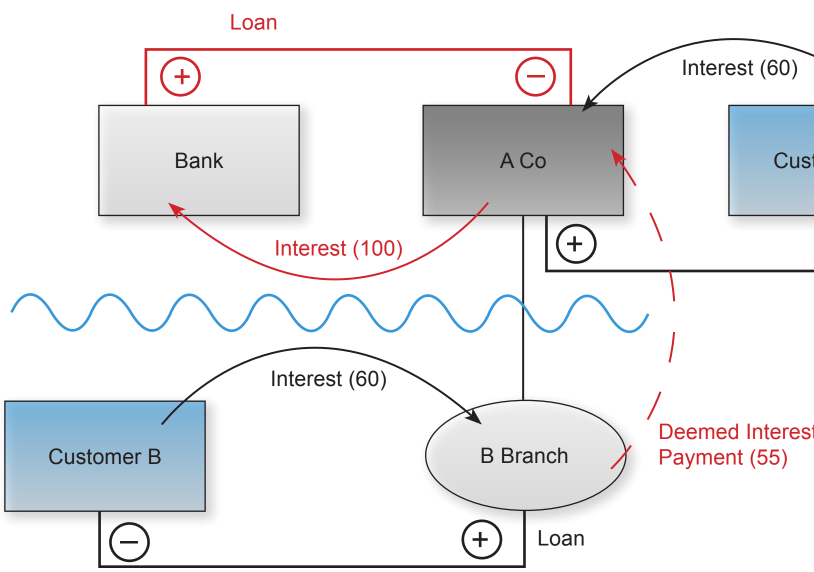
6 Dual inclusion means that income is recognized in both the branch in Country B and the head office in Country A.

7 In the example, the services income is included in the income of the branch, but neither the income nor the royalty is included by the head office.

be treated as outside the scope of the deemed branch payment rule. The example given is an allocation of third party-interest expense of the head office in Country A to its branch in Country B.

In the example, A Co is a company established and resident in Country A. A Co borrows money from an unrelated bank and on-lends half of the borrowed funds to Customer A, a customer located in Country A. A Co lends the remaining portion of the funds to Customer B, a customer located in Country B. The transaction is carried out through B Branch, located in Country B. Country B law calculates the net income of B Branch as if it was a separate entity for tax purposes. In making this calculation Country B treats B Branch as making an interest payment to the head office. This is illustrated as follows:

Figure 4



Under the laws of Country B, the payment is treated as a notional payment. However, the payment is calculated by reference to a certain percentage of A Co's external borrowing costs. Accordingly, the interest expense claimed under Country B law should not be treated as a deemed payment for the purposes of the deemed branch payments rule, as it represents an allocation by the taxpayer of third-party interest costs to the branch. Similarly, a deemed interest payment between the branch and the head office should not be subject to adjustment under this rule to the extent the payment made by B Branch corresponds to an actual allocation of third-party interest expense by the head office under Country A law.

Observation

Different profit attribution methods and expense allocation methods may lead to an actual mismatch. In those instances, an adjustment should be required. Otherwise, no adjustment is required. Unlike hybrid mismatch arrangements where the distinction between disregarded and deductible hybrid payments is based on the legal form of the arrangements, the distinction between the deemed and DD branch payment rules, discussed below, turns on the accounting and tax treatment adopted by the branch and the head office, and the transfer pricing adjustments that are used for arriving at an accurate assessment of the net income in each jurisdiction. Given that these calculations and adjustments are made by the same taxpayer, there does not appear to be any immediate difficulty in determining whether the DD or deemed branch payment rule should be applied, and either rule will be sufficient to neutralize the mismatch.

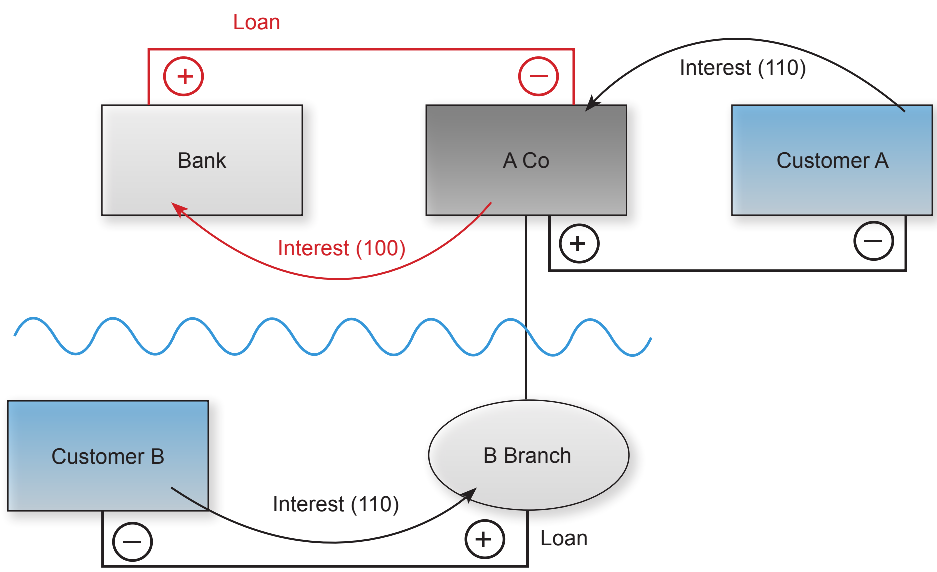
DD BRANCH PAYMENTS

According to the Action 2 Report the O.E.C.D. recommendations on DD outcomes may extend to branch structures. To clarify whether branch arrangements are "hybrid" the Discussion Draft includes examples illustrating scenarios that are deemed to fall within the scope of the Action 2 Report.

A DD branch payment occurs where the rules for allocating income and expense between a branch and the head office allow a deduction in both the Branch Jurisdiction and the Residence Jurisdiction for the same expense without an inclusion of income. For example, A Co is a company established and resident in Country A, and it has lent money to Customer A, located in Country A. A Co borrows additional funds from a bank and uses those funds to make a loan to Customer B, a customer located in Country B, through B Branch, a branch established in that country. Income attributable to B Branch is exempt or excluded from Country A taxation under Country A domestic law or under a tax treaty between Country A and Country B. This is illustrated by the following:

"The distinction between the deemed and DD branch payment rules . . . turns on the accounting and tax treatment adopted by the branch and the head office, and the transfer pricing adjustments that are used."

Figure 5



In this case, the domestic rules governing allocation of interest expense can result in a DD outcome where Country A applies a fungibility approach to the deduction of interest expense while the domestic law of Country B allows the branch to apply a tracing approach. The fungibility approach used in Country A allows for half the amount of the interest expense incurred on the borrowing used to fund the loan to Customer B to offset a portion of the interest income derived from Customer A. At the same time, the entire amount of the interest expense incurred on the borrowing to fund the loan to Customer B is deductible under Country B law to offset the interest income derived from Customer B.

O.E.C.D. Recommendations

The Discussion Draft provides that the Residence Jurisdiction should apply the primary response. Country A should deny A Co's duplicate deductions to the extent they give rise to a mismatch in tax outcomes. The head office would be entitled to carry the denied interest deduction forward in accordance with its ordinary domestic rules and this deduction would be available to offset future dual inclusion income. In the event Country A does not apply the primary response, Country B should deny B Branch a deduction for the payment, to the extent necessary to prevent that deduction from being used to offset income that is not dual inclusion income.

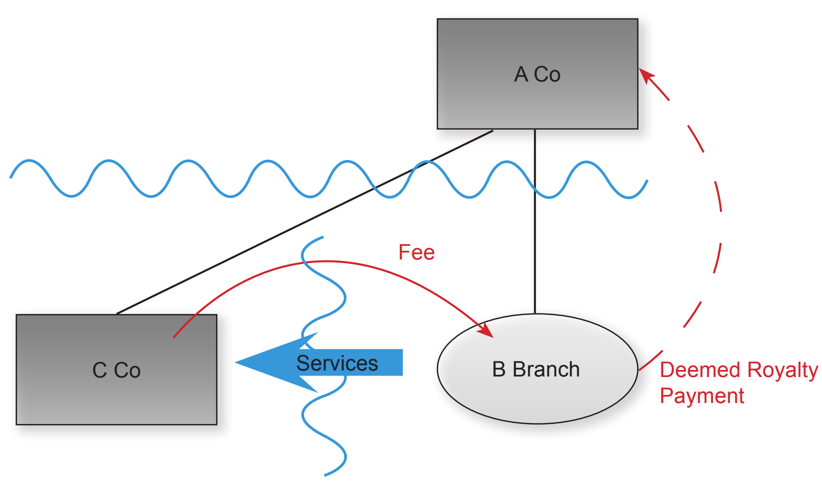
Observation

The recommendation assumes that both A Co and B Branch are fully profitable. The discussion draft does not address circumstances in which B Branch has a net operating loss carryover that eliminates taxable income without taking into account the interest expense incurred by A Co and deducted by B Branch. Should Country A apply the primary response in these circumstances, or should it defer application of the rule until B Branch becomes profitable for income tax purposes? If Country A imposes the rule immediately, branch losses may potentially become stranded. Alternatively, if A Co operates at a loss, can it take advantage of the rule to establish a loan that will not produce full deductions in order to immediately access an expiring net operating loss?

IMPORTED BRANCH MISMATCHES

An imported branch mismatch arises when a taxpayer uses a deduction in a branch mismatch to offset a payment received by a third party. The fact pattern described above regarding deemed branch payments is used to illustrate the mismatch. Thus, B Branch uses I.P. owned by A Co in providing services to C Co. C Co is a subsidiary of A Co. In the example, C Co pays a deductible service fee A Branch C Co. The fee is exempt from tax under Country A law. In Country B, B Branch offsets the fee with a deemed royalty payment that is deductible. Neither Country A nor Country B has adopted a rule addressing the mismatch in tax outcomes arising from the notional payment. The fact pattern is as follows:

Figure 6



O.E.C.D. Recommendations

To neutralize the imported branch mismatch, the O.E.C.D. recommends using the same solutions it described in the Action 2 Report.[8] The treatment of imported mismatches should be the same whether they arise through the use of a branch or a hybrid mismatch structure. In addition, the imported branch mismatch rule applies only to payments made under a structured arrangement or between members of the same group.

Observation

Rules to take care of imported branch mismatches will likely be complex and could result in a territory's right to impose tax on profits that, under common source rules, would be allocated elsewhere. An opt-out similar to reservations to the O.E.C.D. Model Convention may be a solution.[9]

"Rules to take care of imported branch mismatches will likely be complex and could result in a territory's right to impose tax on profits that, under common source rules, would be allocated elsewhere."

CONCLUSION

While the recommendations provide some clarification on the treatment of branch income that results in mismatches, they will undoubtedly lead to complex problems in terms of their application. In addition to inconsistencies with domestic tax principles, domestically drafted legislation may be too narrow or too broad, leading either to additional litigation in the former the case or double taxation in the latter. Taxpayers should seek involvement, directly or indirectly, in the O.E.C.D. discussion process, even if the deadline for comments has passed. Comments on the Discussion Draft[10] will be addressed in the next edition of *Insights*.

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8 Ruchelman, "O.E.C.D. Discussion Drafts Issued Regarding B.E.P.S. Action 2."

9 An opting-out provision was, for instance, suggested for the O.E.C.D.'s Action 15 report on the development of a multilateral instrument to implement tax treaty revisions related B.E.P.S.; also, Robert Stack, the U.S. Department of Treasury's deputy assistant secretary for international tax affairs, indicated earlier this year that the U.S. may opt-out of the O.E.C.D.'s new standards for P.E.'s as outlined in the B.E.P.S. Action 7 report.

10 See comments received by the O.E.C.D., published on September 23, 2016 and available at http://www.oecd.org/ctp/aggressive/Comments-Discussion-draft-branch-Mismatch-Structures.pdf.