OECD final report on branch mismatch structures

25 August 2017

In brief

The OECD, on 27 July 2017, released its report, *Neutralising the Effects of Branch Mismatch Arrangements Action 2*. The report recommends domestic law changes to neutralise the effect of certain payments or deemed payments involving branches. The report expands the final Base Erosion and Profit Shifting (BEPS) Action 2 paper, *Neutralising the Effects of Hybrid Mismatch Arrangements*, issued on 5 October 2015.

This additional report turns the 30 pages of the August 2016 discussion draft into 104 pages of detail. It still identifies the same five basic types of branch mismatch arrangements targeted, but it adjusts some of the recommendations and incorporates some of the comments. There are more illustrations and examples, running through the identification of a mismatch and the recommended adjustments necessary.

These recommendations are not a minimum standard, but some countries may choose to adopt all or part of them. Furthermore, companies will have to consider carefully whether any of their current arrangements may be adversely affected.

The level of complexity involved in these branch hybrid rules, added to the existing complexity already found in the BEPS Action 2 recommendations, suggests that some countries may find it difficult to introduce them in full. As with the original report, there remains the risk of economic double taxation or inconsistent application, thereby impacting other tax, commercial or regulatory outcomes.

In detail

Background – development of recommendations

The OECD has published recommendations for domestic laws that would neutralise the effect of payments involving certain branch mismatch arrangements (Final Branch Hybrids Report). This aims to build on the October 2015 report under BEPS Action 2, *Neutralising the Effects of Hybrids Mismatch Arrangements,* which called for action to adjust the tax consequences in either the payer or payee territory of various inter-company payments (as discussed in our November 2015 Tax Policy Bulletin). That report noted further plans to consider similar branch situations and a discussion draft asked for comments on various proposals (see our August 2016 Tax Policy Bulletin).

The term 'payment' in the Final Branch Hybrid Report includes rents, royalties, interest, payments for services and other payments that may offset ordinary income under the laws of the payer jurisdiction (as it does in the main BEPS Action 2 Report). However, it does not

include the cost of acquiring an asset nor an allowance for depreciation or amortisation. The report identifies five basic types of branch mismatch arrangements, as in the discussion draft:

- *disregarded branch structures,* where the branch does not give rise to a permanent establishment (PE) or other taxable presence in the branch jurisdiction
- *diverted branch payments,* where the branch territory recognises the branch's existence, but the payment made to the branch is treated by the branch jurisdiction as attributable to the head office, while the residence jurisdiction exempts the payment from taxation on the grounds that the payment was made to the branch
- *deemed branch payments,* where the branch is treated as making a notional payment to the head office that results in a mismatch in tax outcomes under the laws of the residence and branch jurisdictions
- *double deduction (DD) branch payments,* where the same item of expenditure gives rise to a deduction under the laws of both the residence and branch jurisdictions, and
- *imported branch mismatches,* where the payee offsets the income from a deductible payment against a deduction arising under a branch mismatch arrangement.

Two of these five types – the disregarded branch and diverted branch payment - are combined into one recommendation in the Final Branch Hybrids Report because they both involve branch payee structures that give rise to deduction/ non-inclusion (D/ NI) outcomes. The other three types each have one recommendation. These rules should not apply, the report states, when the reason for the mismatch is that the payee is exempt from tax, subject to a special tax regime or resident in a zero-tax jurisdiction. Mismatches that arise solely due to measurement or timing differences also are not within the recommendations' intended scope. Adjustments under these four recommendations should only be made after applying the ordinary domestic rules for allocating branch income, subject to the requirements of any relevant treaty.

A fifth overarching recommendation deals with limiting the scope of an existing branch exemption. The report defines this as Recommendation 1, with the other four numbered consecutively after that.

PwC Comment: Whilst straightforward in concept, the operation of the rules likely will be complex, especially with regard to the interaction with the already difficult area of profit attribution to branches.

Recommendation 1 - Limitation to the scope of the branch exemption

The overarching recommendation of the Final Branch Hybrids Report is that jurisdictions that provide an exemption for branch income should consider limiting the scope and operation of this exemption to properly take into account, under the laws of the branch jurisdiction:

- the effect of deemed payments (a so-called 'misallocation'), or
- payments that are disregarded, excluded or exempt from taxation.

This recommendation does not specifically target branch mismatches alone. It would apply to a wider range of payments.

PwC Comment: This recommendation appears to introduce a 'subject-to-tax test' for the operation of a country's branch exemption. However, it recognises that it is not necessary to include non-taxable branch income as income of the head office, where that income would benefit from an exemption (such as a dividend participation exemption) in the head office jurisdiction. The report helpfully suggests that the recommendation should not be interpreted as requiring countries to change any deliberate policy decisions they have made (e.g. equality of treatment between subsidiaries and branches). Moreover, the report's recommendations are not intended to affect a country's obligations under a tax treaty, which may anyway prevent a territory from limiting the scope of its branch exemption.

Recommendation 2 - Branch payee mismatch rule

The first two types of mismatches are D/NI outcomes. They apply where a payment is made to a branch by a third party under a structured arrangement, or between members of a controlled group, with the definitions applied as in the main BEPS Action 2 Report. The mismatch arises if it is deductible for the payer and is:

- to a branch that does not create a taxable presence in the branch jurisdiction, but is still seen as a branch by the head office jurisdiction, or
- treated by the branch jurisdiction as made to the head office and vice versa (or between two branch jurisdictions), so that it is not taxed.

The broad recommendation, albeit somewhat artificially split into three parts, is that the payer jurisdiction

should deny a deduction for such a mismatch payment.

The recommendation suggests that countries may wish to consider not applying the rule where the branch income is subject to inclusion under the CFC rules of another jurisdiction.

PwC Comment: These branch mismatch rules are not intended to apply where the reason for the non-taxation is that the branch is established in a non-taxing jurisdiction. In such circumstances Recommendation 1 above would, however, still be in point.

Recommendation 3 - Deemed branch payments

A mismatch arises where a branch is deemed to make a payment to its head office (or another part of the same taxpayer) in circumstances where:

- the payment is deductible in the branch territory against income that is not taxed in both jurisdictions, and
- there is no corresponding income recognition by the company.

The report provides an illustration where a branch territory recognises the use of intangibles owned by the head office in producing service income from a related company and deems a royalty payment to the head office, while the head office territory recognises the intangibles as owned by the branch, while all of the branch income is exempt.

The report's recommendation is somewhat complex, but it broadly denies the deduction for the deemed branch payment in these circumstances, to the extent the corresponding income is not recognised by the head office. The need for a secondary rule forcing inclusion in the head office territory is no longer considered necessary, as it had been in the earlier discussion draft on branch hybrids.

The application of tax or accounting principles, as well as income allocation principles in the branch jurisdiction can give rise to deemed or notional payments. It is irrelevant if a payment is documented in determining whether it is notional. But this recommendation alone is not intended to apply to amounts calculated by reference to actual expenditure.

This recommendation will not apply if the deemed payee jurisdiction recognises the deemed payment by including it as income, or if the head office jurisdiction allocates expenditure or loss of an equivalent category to the payer jurisdiction. This has an effect equivalent to disallowing the expenditure in that jurisdiction. The required 'tracing' or 'like-kind' approach here is likely to prove significantly complex.

A deemed payment can be recognised as income in the payee jurisdiction even if it then attracts an exemption or exclusion.

Insofar as there will be no mismatch if the deduction offsets dual inclusion income (i.e. amounts broadly taxed in both jurisdictions), the receipt of double tax relief in the head office jurisdiction for tax paid at the branch level generally is ignored.

PwC Comments: This recommendation is very complex. For example, it may result in adjusting the branch computation based on expenditure at the head office for which the branch jurisdiction has no real visibility.

It will be important to make sure that differences in profit attribution methods do not give rise to adjustments where there is no actual mismatch. Note that the OECD's June 2017 Discussion Draft Additional Guidance on Attribution of Profit to Permanent Establishments encourages an analysis based on the assumption of a deemed payment from a branch to its head office giving rise to more potential tax mismatches that may result in inappropriate denial of deductions or taxation of income.

Recommendation 4 - Double deduction (DD) branch payments

A mismatch arises where a payment is deductible under the rules of more than one jurisdiction to the extent that it offsets income that is not taxable in every jurisdiction where a deduction is effectively achieved (i.e. against non-dual inclusion income).

The report provides an illustration where a deduction for the same expenditure item is allowed under the laws of both the branch territory and the residence territory, but the branch income is taxable only in the branch territory. It also suggests that a similar result is possible where the branch is taxable in the residence territory if the branch's expenses or losses can also offset the income of a person other than the taxpayer and that other person's income is not taxable in the residence territory (e.g. a subsidiary which can be tax consolidated with the branch).

The report recommends, as a primary response, that the head office/ investor territory deny the deduction. As a secondary response, the branch territory would deny the deduction. However, any deduction should be eligible to offset dual inclusion income (income that is taxed in both territories where a deduction is given), whether arising in a current or subsequent period.

PwC Comments: For larger branches, it is helpful that the report envisages a flexible approach. This approach suggests that the taxpayer could determine the amount of double deductions on an aggregate basis by comparing the total deductions claimed for actual expenditure and loss in each jurisdiction to the taxpayer's total relevant expenditures, rather than a strict line-by-line comparison.

This recommendation could potentially result in stranding branch losses, which would seem to go beyond the scope of the objectives. Accordingly, the Report notes that tax administrations may permit taxpayers to offset any excess against non-dual inclusion income in certain circumstances. A jurisdiction also has the flexibility to make the adjustment under the double deduction rule when the deduction arises or when the deduction actually offsets dual inclusion income under the payer jurisdiction's laws.

Recommendation 5 - Imported branch mismatches

An imported branch mismatch arises where, under the laws of two territories, a branch is deemed to make a payment to its head office (or another part of the same taxpayer) in circumstances where it is deductible in the branch territory and there is a corresponding income recognition in the branch for an amount which is deductible in a third jurisdiction (i.e. the result is imported into that third territory without any mismatch rules applying in the residence and branch territories).

The report recommends that for a payment made under an imported branch mismatch arrangement, the payer jurisdiction should deny a deduction to the extent that such payment directly or indirectly funds the deductible expenditure. The imported mismatch rules apply to payments under a structured arrangement or within a controlled group.

The same tracing and priority rules should apply for determining the extent to which a payment directly or indirectly funds a deductible expenditure under an imported branch mismatch arrangement similar to the BEPS Action 2 Report.

PwC Comments: As with the imported mismatch rules in the main BEPS Action 2 Report, these rules are very complex and require extensive knowledge of the group's activities in overseas territories. These may only have limited connection with the payer's activities.

Illustrations and examples

Annex B of the Final Branch Hybrids Report has 43 pages of detailed examples which, except for the first and last, include numerical calculations as well as descriptions of adjustments for specific circumstances. These examples involve the following situations:

- Example 1: Branch payee mismatches
- Example 2: Notional payment by taxable branch
- Example 3: Taxable branch with non-dual inclusion income
- Example 4: Notional payment by exempt branch
- Example 5: Application of Recommendations 3 and 4 to notional payment
- Example 6: Application of primary rule in Recommendation 4 to taxpayer with multiple branches
- Example 7: Application of secondary rule in Recommendation 4 to taxpayer with multiple branches
- Example 8: Allocation of third party expenses under Recommendation 3
- Example 9: Allocation of third party expenses under Recommendation 4
- Example 10: DD outcomes and treating mismatch as arising at the time of offset
- Example 11: Imported mismatch

The takeaway

These rules intend to comprehensively neutralise any mismatch in tax outcomes arising from the use of branch structures.

The OECD states that it seeks to ensure that the branch mismatch rules and hybrid entity/ instrument rules will operate together in a coherent and co-ordinated way.

As these branch hybrid rules have developed they have become increasingly complex. Given the nature of branches, some complexity appears inevitable. Indeed the report's length is in part due to attempts to clearly explain and illustrate a number of the concepts.

As with the main hybrid rules, there appears to be a risk of economic double taxation or impact on other tax, commercial or regulatory outcomes through inconsistent application of the recommendations.

Companies should carefully consider whether any of their current arrangements may be adversely affected by these branch mismatch rules if adopted by relevant countries.

Let's talk

For a deeper discussion of how these proposals might impact your business, please call your usual PwC contact. If you do not have a contact or would prefer to speak to one of our global specialists, please contact one of the individuals below:

Global Tax Policy Contacts

Stef van Weeghel, *Amsterdam*
+31 (0) 88 7926 763
stef.van.weeghel@nl.pwc.com

Aamer Rafiq, *London*
+44 (0) 20 721 28830
aamer.rafiq@uk.pwc.com

Pam Olson, *Washington*
+1 (202) 414 1401
pam.olson@us.pwc.com

Phil Greenfield, *London*
+44 (0) 20 7212 6047
philip.greenfield@uk.pwc.com

Edwin Visser, *Amsterdam*
+31 (0) 887923611
edwin.visser@nl.pwc.com

Will Morris, *London*
+1 (202) 312 7662
william.h.morris@pwc.com

Dave Murray, *London*
+44 (0) 7718 980 899
david.x.murray@pwc.com

Other Contacts

Jonathan Hare, *London*
+44 (0)20 7804 6772
jonathan.hare@uk.pwc.com

Michael Urse, *Cleveland*
+1 (216) 875-3358
michael.urse@us.pwc.com

Calum Dewar, *New York*
+1 (646) 471-5254
calum.m.dewar@us.pwc.com

Suchi Lee, *New York*
+1 (646) 471-5315
suchi.lee@us.pwc.com