OECD releases discussion draft on branch mismatch structures

25 August 2016

In brief

On 22 August 2016 the OECD published, for discussion, recommendations for domestic laws that would neutralise the effect of payments involving certain branch mismatch arrangements.

This expansion of the final Base Erosion and Profit Shifting (BEPS) Action 2 paper, *Neutralising the Effects of Hybrid Mismatch Arrangements*, issued on 5 October 2015, adds even more complexity to that very long and complicated hybrid mismatch guidance.

The new Discussion Draft applies the analysis and recommendations set out in the Action 2 Report to mismatches that can arise through the use of branch structures. It identifies five basic types of branch mismatch arrangements and sets out preliminary recommendations for domestic rules that would neutralise the resulting mismatch in tax outcomes.

If the OECD finally recommends these rules in a consensus document, to the extent countries choose to adopt all or part of them, companies will have to carefully consider whether any of their current arrangements may be adversely affected.

In detail

Background – October 2015 final report

The Report on Neutralising the Effects of Hybrids Mismatch Arrangements (Action 2 Report) sets out recommendations for domestic rules designed to neutralise mismatches in tax outcomes that arise in respect of certain payments under a hybrid mismatch arrangement, which the OECD describes (in a 22 August press release, also reproduced on page 3 of the Discussion Draft) as:

- "*deduction/ no inclusion (D/NI) outcomes*, where the payment is deductible under the rules of the payer territory but not included in the ordinary income of the payee;
- *double deduction (DD) outcomes*, where the payment triggers two deductions in respect of the same payment; and
- *indirect deduction/ no inclusion (indirect D/NI) outcomes*, where the income from a deductible payment is set-off by the payee against a deduction under a hybrid mismatch arrangement."

As explained in our November 2015 Tax Policy Bulletin, the Action 2 Report includes specific recommendations to address hybrid instruments or entities by:

- amending domestic law to reduce the frequency of such mismatches, and
- adjusting the tax consequences in either the payer or payee territory in order to neutralise the hybrid mismatch (without disturbing any of the other tax, commercial or regulatory outcomes).

The new Discussion Draft applies the analysis and recommendations set out in the Action 2 Report to mismatches that can arise through the use of branch structures. It identifies five basic types of branch mismatch arrangements (paragraph 1.3):

- "*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 existence of the branch 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;
- *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."

The Discussion Draft sets out, for comment, possible recommendations for domestic rules that would adapt, to branches, those recommendations in the Action 2 Report that apply to instruments and entities. The OECD regards these as closely aligned.

Disregarded branch structures

According to the Discussion Draft, a mismatch may arise where a head office excludes branch income from tax in its territory of residence while it is not taxed by the recipient branch territory. The Discussion Draft provides three examples where this might arise:

- the resident territory's domestic rules exempt the branch income, but the branch territory's domestic rules don't treat it as a taxable presence there
- as above, except the exemption arises because the branch is a PE under the treaty between the two countries and the residence jurisdiction is accordingly required to exempt the branch under the terms of the treaty
- as above, except the branch is not a PE under the treaty between the two countries and so the branch jurisdiction is precluded from taxing the income under the terms of the treaty.

The Discussion Draft recommends that the residence territory adjust the branch exemption so that amounts that are disregarded, exempt or excluded from taxation in the branch territory are treated as if they had been received directly by the head office (and outside the exemption for branch income).

Observations: This adjustment would seem to be quite far reaching and potentially introduce a 'subject-to-tax' requirement for branch exemptions. This may raise a number of difficulties. For example it would appear to create inconsistencies for jurisdictions that have adopted a territorial tax system.

The Discussion Draft also notes that tax treaties may prevent the residence territory from limiting the scope of the branch exemption. So, if the income is still not taxed (including under a controlled foreign company (CFC) rule), it recommends an adjustment to deny deductions for the payer in certain arrangements which are structured (as defined for the Action 2 Report) or involving members of the same group.

Observations: It would appear that the branch mismatch rules could lead to a disallowance in situations in which, were the payment made to a company located in the branch jurisdiction, no disallowance would arise under the main Action 2 recommendations. This could occur, for example, with branches in non-taxing territories. Hopefully this inconsistent approach to branches will be addressed.

Diverted branch payments

According to the Discussion Draft, a mismatch may arise from a difference between the laws of the residence and branch territories in the attribution of payments to the branch. For example, a mismatch may occur when a branch territory treats a receipt as if it was made directly to the head office, while the head office territory treats the receipt as made to the branch.

The recommendation in the Discussion Draft that the residence territory adjust the branch exemption to treat amounts as received directly by the head office, as mentioned above, would neutralise this diverted branch payment mismatch.

Observations: It would be administratively less burdensome if adjustments were avoided in circumstances when the head office would not tax a receipt of that nature. For structured arrangements and payments within a group, the Discussion Draft advocates potentially denying the deduction for the payee.

Deemed branch payments

According to the Discussion Draft, a mismatch may arise if a payment is deemed to be made by a branch to its head office in circumstances in which it is deductible in the branch territory but there is no corresponding income recognition.

The Discussion Draft provides an example of a branch territory recognising the use of (and transfer price for) intangibles owned by the head office in producing service income from a related company, while the head office territory recognises the intangibles as owned by the branch and the income as exempt branch income.

The Discussion Draft recommends denying the deduction for the deemed branch payment (to the extent the corresponding income is not recognised, and in that respect it may be carried forward). As a secondary rule, if the branch territory doesn't deny the deduction the Discussion Draft recommends that the head office territory should treat the deemed payment as ordinary income to the extent that the payment gives rise to a branch mismatch.

Observations: Differences in profit attribution methods should not give rise to adjustments in which there is no actual mismatch.

DD branch payments

The Action 2 Report contemplates that its recommendations (in Chapter 6) on DD outcomes would extend to situations involving the use of branch structures. However, there may be a lack of clarity over whether some branch arrangements are 'hybrid', so the Discussion Draft sets out to illustrate situations that fall within the Action 2 Report and would be subject to adjustment under those rules.

The Discussion Draft provides examples in which the rules for allocating income and expenditure between the branch and the head office allow a deduction for the same expenditure item under the laws of the branch territory and residence territory. In one complex example, the head office territory has a fungible approach to interest expense deductions, while the branch territory allows the branch to apply a tracing approach.

Applying the Action 2 Report recommendations, the primary response calls for the head office territory to deny duplicate deductions, while the secondary response calls for the branch territory to deny the branch deduction.

Observations: This could potentially result in stranding branch losses, which would seem to go beyond the objectives' scope.

Imported branch mismatches

According to the Discussion Draft, a branch mismatch may arise under the laws of two territories and the result imported into a third territory. The Discussion Draft suggests the most appropriate and effective way to neutralise the mismatch is for either the head office territory or branch territory to neutralise the mismatch. However, it recommends an imported mismatch rule to deny the deduction for any payment that is directly or indirectly set-off against any type of branch mismatch payment.

For payments made under a structured arrangement or between members of the same group, the Discussion Draft proposes that the working party adopt the Action 2 Report recommendations in Chapter 8. As a result, the treatment of imported mismatches would be the same regardless of whether they arose through the use of a branch or hybrid mismatch structure and the guidance in the Action 2 Report on tracing and priority could equally apply.

Observations: These imported mismatch rules could potentially lead to a territory taxing profits which really don't belong there on a traditional source and revenue analysis. The recommendations are particularly complex in many respects and require extensive knowledge of group activities. Therefore, territories may be reluctant to adopt them. The OECD could recognise this from the outset and offer an opt-out solution subject to certain criteria.

The takeaway

The intention of these rules is to comprehensively neutralise any mismatch in tax outcomes arising from the use of branch structures (regardless of the accounting treatment applied in the branch or head office).

The OECD states in the Discussion Draft that it seeks to ensure that the branch mismatch rules and hybrid entity/ instrument rules would operate together in a coherent and co-ordinated way and prevent taxpayers from responding to the implementation of the recommendations in Chapter 3 of the Action 2 Report by switching to branch structures that provide them with the same tax advantages.

The Discussion Draft repeatedly refers to avoiding the risk of economic double taxation or disturbing any of the other tax, commercial or regulatory outcomes. However, there appears to be a serious risk that this may still occur.

The complexity of these additional rules make an already very complex action item very difficult for countries to fully enact and implement in practice.

Comments are due by 19 September 2016. We encourage multinational companies to consider how these proposals would affect their existing organisation structures should they be adopted as consensus recommendations.

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

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

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

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

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

Other Contacts

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

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

SOLICITATION

© 2016 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 208,000 people who are committed to delivering quality in assurance, tax and advisory services. Find out more and tell us what matters to you by visiting us at www.pwc.com