Compilation of comments

BEPS ACTION 2

BRANCH MISMATCH STRUCTURES

23 September 2016

OECD

BETTER POLICIES FOR BETTER LIVES

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19 September 2016

Dear Sir/Madam

BEPS ACTION 2 - BRANCH MISMATCH STRUCTURES

The BBA and AFME welcome the opportunity to make this written submission in response to the OECD's discussion draft published on 22 August 2016 entitled 'BEPS Action 2 - branch mismatch structures'.

The BBA is the leading trade association for the UK banking sector with 200 member banks headquartered in 50 countries, with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA.

The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions.

Need for further consultation on detailed proposals

We are concerned that there has been a comparatively short period of time for comments to be submitted, particularly given that the consultation period has overlapped with a number of other OECD consultations and the summer period in Europe.

As set out in more detail below, we believe that if the OECD wishes to take proposals forward they should address specific and targeted issues that result in mismatches arising from planning using permanent establishments (PEs). For the reasons stated below, we are concerned that the introduction of more general rules, which in effect revise the standard approach to the taxation of permanent establishments without addressing the equivalent risks of double taxation and which could cause additional complexity or unintended consequences.

We would strongly encourage the OECD Secretariat to consult further on more detailed and specific proposals prior to adopting any recommendations.

Overview

The banking sector conducts a wide range of activities through sizable and active trading branches in many countries. These branches undertake many financial transactions with third parties and, in many cases, have substantial balance sheets. We think that it is critical that any policy recommendations made by the OECD do not inadvertently undermine the existing rules regarding the taxation of such substantive trading branch operations.

We therefore believe that a different approach is needed to ensure that any hybrid mismatch rules applying to branches target only those situations in which permanent establishments (PEs) are being used to achieve situations equivalent to those addressed by the OECD's final recommendations on Action 2 published in October 2015.

We note that many of the existing differences in the taxation of branches arise as a result of a policy differences in the taxation of branches in the home country and the branch, rather than as the result of tax planning by businesses.

In particular, many of the examples which are discussed in the discussion draft arise solely as a result of exemption rules which apply in the home country. As a general matter, it does not appear to be appropriate for OECD recommendations to displace a policy decision that has been made in the home country to exempt what it considers to be the profits of the PE. The exempt profits in the home country should not be affected by policy choices in the branch country as to tax rate, quantum of profits, etc.

As noted, rather than a general approach, which partially revises branch taxation but fails to address when the same circumstances would give rise to double taxation, we would only encourage targeted rules aimed at specific transactions involving branches that are considered to involve a BEPS risk. However, we would also suggest that consideration is given to whether those transactions are in fact already addressed by the recommendations in other BEPS actions (particularly Actions 2 (Neutralising the effects of hybrid mismatch arrangements), 7 (Preventing the artificial avoidance of PEs) and 8-10 (Aligning transfer pricing outcomes with value creation)) before any targeted rules are needed. This approach is more likely to achieve an outcome that is consistent with the OECD's final recommendations Action 2 published in October 2015.

Without a targeted approach, we believe that the stated aims[1] of the discussion draft are unlikely to be achieved by the recommendations included within the discussion draft. Rather, they are likely to fundamentally alter the existing tax treatment of branches and/or introduce double taxation between home and branch country.

In effect, the proposals in the discussion draft appear to address the symptom of an underlying issue, and not the root cause. In relation to the existing rules, the OECD's suggested approach risks increasing uncertainty, adding complexity, creating unintended consequences, and creating practical tax compliance challenges.

Experience from the UK implementation of branch mismatch rules

We note that the UK has already sought to introduce hybrid mismatch rules involving branches as part of the wider implementation of the UK's hybrids legislation.

As a consequence, we are familiar with a number of concerns which also appear to arise under the recommendations set out in the current OECD discussion draft. Where possible, we have highlighted these concerns below.

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[1] Paragraph 6 of the discussion draft states that the intention of branch mismatch 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) while avoiding the risk of economic double taxation or disturbing any of the other tax, commercial or regulatory outcomes"*

Key concerns with the OECD recommendations

a. Rules should not displace exemption regimes or double tax treaties

The proposed solution for both disregarded branches and diverted branch payments is the restriction of the scope of the branch exemption in the head office country. This is also proposed as a secondary rule in relation to deemed branch payments. Where the head office country has made a policy choice to operate an exemption regime, then the measure of tax deductions in the branch would not affect the tax paid in the head office country.

The decision to exempt income in a branch is a policy decision for the head office country, and it is not clear that the OECD's recommendations should seek to displace such policy decisions, and certainly not as a general – but partial – revision to branch taxation. As noted earlier, this is on the basis that the exempt profits in the home country should not be affected by policy choices in the branch country as to tax rate, quantum of profits, etc. In the case of the UK, for example, UK resident companies may have made irrevocable elections to exempt branch income and expenses from inclusion in the tax calculations of the head office. Displacing those elections could produce unintended consequences for such UK resident companies.

If there are to be any restrictions, they should be targeted towards the non-inclusion of the expense in the branch location, focussed on genuine attempts to produce a hybrid mismatch and we believe should not displace established exemption regimes.

We note that the existence of a branch would be governed by the double taxation treaty established between two countries. Such treaties are subject to extensive negotiation between countries, and care needs to be taken in applying any rules that could override bespoke and considered agreements.

b. Use of the dual inclusion income test

We note that the proposals could impact a number of PE ordinary course of business trading situations. The type of situations that could be caught include head office cost recharges, intra-group financing transactions, and booking model allocations imputing expenses/losses to PEs. The concern is that even when where there is no hybrid effect (i.e. no double deduction) there could still be a disallowance in the PE – presumably an unintended consequence of the current drafting.

In relation to deemed branch payments, there will be an insufficient inclusion both where there is an exemption methodology for branch income in the home country, and where an entity is taxed as a single global entity on worldwide income, as that will only tax transactions with external parties.

To provide an example, the tax computation of a banking branch may include sizable deductions for amounts that are regarded as interest payments to head office. These amounts are not likely to be included in the ordinary income of the bank in the head office jurisdiction, which will normally tax the overall profit of the bank unless the bank benefits from a branch exemption regime (in which case again the corresponding income is not included).

In the case of an exempt branch, the proposals could override the branch exemption to the extent the branch's tax computation includes deductions for amounts treated as paid to the head office. Such deductions are likely to be sizable in the banking sector, given the significance of funding costs. We trust that this is not intended, and believe that, as a minimum, substantive trading branches should be excluded (see below). If this change is intended, it is a fundamental change to the operation of branch exemptions and we believe that this should be subject to consultation in the wider context of branch taxation as a whole.

We appreciate that some degree of safeguard is intended to protect against the above concerns in relation to deemed branch payments, and in relation to double deduction branch payments. This is by virtue of the proposal that there should not be a counteraction where the deemed deduction or the double deduction respectively, is deducted from dual inclusion income. In both cases, we do not believe that that would achieve adequate protection for the following reasons.

1) The income (including the third party income) of exempt branches will not be subject to dual inclusion.

2) It may be in some cases that the branch expenses, including funding costs, exceed the gross income of the branch on a temporary basis, e.g. because of local trading conditions. This should create a trading loss in the branch. We believe that it should continue to be permitted for that loss to: (i) be relieved in full against profits of the bank in the head office jurisdiction, where a worldwide basis of taxation operates; and, (ii) for the branch to carry the loss forward regardless of the basis of taxation in the head office jurisdiction. In both cases, neither the branch nor the head office should be subject to a counteraction imposed by the hybrid mismatch rules.

3) This approach seems to require an assessment of every item of income of the branch to determine if it is included in both the branch and head office jurisdictions. This is unlikely to be practical in a sizable trading bank branch. Furthermore, we do not believe that a hybrid mismatch rule should apply where there are minor differences between the two jurisdictions' approach to attribution of profits to a PE.

   For typical trading branches of banks, the two jurisdictions will consider broadly the same taxable economic profit to arise in the PE, but have differences of approach in the detail of the attribution calculations. In our view, this is not hybridity, and could just as likely result in double taxation. Any approach to addressing hybrid mismatches should not require every slight difference in attribution to the branch to be identified and subject to some adjustment under the hybrid mismatch rule (and certainly not without addressing the double taxation which is just as likely to arise from such minor differences in the context of an operating branch).

We are therefore concerned by the example provided in the table in Paragraph 41 of the discussion draft. We understand that the question of differing views on attribution of profits to a PE is relevant to cases such as the intellectual property charges set out in Figure 3 (see Paragraph 28 of the discussion draft). However, as set out above, we do not believe that a hybrid mismatch rule should apply where there are minor differences between the two jurisdictions' approach to attribution of profits to a PE. We therefore believe that the approach to tackling cases such as that set out in Figure 3 needs to distinguish the normal taxation of an operating branch.

Again, the hybrids rules should not impinge on the taxation of trading branches, and we believe that any policy proposals in this area should be subject to further consultation.

We are not convinced that the concept of dual inclusion income will achieve the desired safe harbour in all cases, and believe that substantive trading branches should be excluded from these measures, except in those cases where an internal structured arrangement is added into the substantive trading branch. A test of whether a branch is a substantive trading operation could include considering whether it is a branch of a regulated entity and/or whether it transacts with a wide range of third party clients/customers.

This should enable an approach to branch hybrid mismatches that addresses only those cases which in essence seek to use a branch to achieve an arrangement that is the target of OECD's final recommendations on Action 2 published in October 2015.

c. Application to third party arrangements

Question 3 asks whether *"…the branch payee mismatch rule [should] apply only to payments made under a structured arrangement or between members of the same control group?"*

Subject to our wider concerns on the appropriate structure for counteractions in relation to branches, we believe that a branch payee mismatch rule should be applied only in those circumstances. However, banks and other organisations cannot be expected to conduct due diligence on the tax affairs of third parties, and given that tax matters are typically confidential, they will not be able to do so.

There are also likely to be many instances where a bank or broker/dealer transacts with a third party in a manner which, in principle, gives rise to a D/NI outcome because of the nature of the payee, but which is not designed to secure that mismatch and is not priced to share the benefit of it. This will particularly include for example transactions with exempt recipients like governments, pension funds or charities. Any rules need to be clear that such transactions are not intended to be caught within the scope of these rules.

d. Capital attribution from a foreign head office to a PE

Question 11 asks *"Are there any practical issues that could arise in applying the branch mismatch rules to a deemed payment between the branch and head office?"*

A PE may satisfy its regulatory capital requirement by reference to the regulatory capital issued by the foreign head office in accordance with the separate enterprise principle. An adjustment (a "capital attribution tax adjustment") is recognised in the PE's tax computation for the difference between its actual funding costs and its notional funding costs (the notional funding costs being what is deductible) calculated under the separate enterprise principle. The relief given for funding costs (which ought to be considered as a share of amounts payable to third parties) should not be within scope of the branch mismatch rules.

Furthermore, due to differences in foreign head office and branch jurisdiction regulation, the capital attribution calculation could be different and lead to different funding costs allocation in the head office and branch jurisdictions respectively. Such differences are not hybrid mismatches as such but reflect differences in tax base between countries.

e. Treatment of third party costs

Question 12 asks *"Do you agree that a payment that is treated (for tax purposes) as made between the branch and head office but which, in practice, results in an allocation of third party expenses should be outside the scope of the deemed branch payment rule?"*

We believe that it is essential that such a payment should be outside the scope of the deemed branch payment rule and that any deemed payment rules do not undermine normal commercial practices where costs may be incurred at group level and reallocated, or incurred by head office on behalf of a branch.

Based on our experience from the implementation of these rules in the UK, we believe that careful consideration is needed to ensure that rules do not inadvertently catch a simple allocation of costs. However, on its own, that requirement does not appear to be sufficient to ensure that a counteraction does not arise for other amounts which might reasonably be treated as payments from a branch to its head office when applying the separate enterprise approach to the branch.

For example, an overseas branch of a bank might be considered to have entered into a range of financial transactions with its head office (for the purposes of determining the taxable profits in the PE jurisdiction) which do not, of themselves, clearly link to a transaction that the head office has undertaken with a third party. For example, the branch considers that it has entered into an interest rate swap with the head office that gives rise to a fair value debit in the branch. The head office is likely to have entered into a range of derivative transactions with third parties, but it may not be possible to say that the branch's debit is clearly a share of a specific third party expense.

f. *Foreign exchange payments*

The treatment of foreign exchange (fx) differences in the recommendations under Action 2 should be replicated here and it should be clarified that fx differences should not be caught by any branch mismatch rules.

g. *Accounting differences*

The OECD's final recommendations on branch mismatches should recognise that differences arising because of the accounting standards applicable in different jurisdictions should not be counteracted. Such differences could, for example, lead to deductions being recognised in different periods in the head offices and branch respectively simply because the two sides of a transaction are not recorded under the same accounting rules (with local tax legislation requiring, in certain instances, the application of a certain GAAP).

We are grateful for the opportunity to provide comments on the OECD's discussion draft. We would be happy to discuss any of the points raised in further detail to assist with your consideration.

Yours faithfully,

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19 September 2016

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BDI Comments on the OECD Discussion Draft "Branch Mismatch Structures"

Dear Sir or Madam,

BDI* refers to the OECD Discussion Draft "Branch Mismatch Structures" issued on 22 August 2016. We would like to thank you for the opportunity to provide our comments that allow us to engage with you on these important issues. We have limited our comments to some general issues.

The BDI basically supports the OECD`s approach to tackle cases of double non-taxation by neutralizing the effects of hybrid mismatch arrangements. It is widely recognized that hybrid instruments and hybrid entities might give rise to intended "double non-taxation", "double deduction" and "long-term deferral" in some cases.

However, as recognized by the discussion draft, branch mismatch arrangements do not always result from differences in the tax treatment of an instrument or entity and therefore are not straightforwardly "hybrid". Nevertheless, some circumstances can lead to similar outcomes as the result of differences in allocating income and expenses between a branch and head office jurisdiction. We would like to emphasise however that the vast majority of branches are not "planned" for to gain a tax benefit, but resulting mismatches simply mirror the ways in which different jurisdictions interact for tax purposes.
Whether branches actually create mismatches is something which is not straightforward to identify. Even in related party situations, the tax treat-

* BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 36 sector associations and represents over 100,000 large, medium-sized and small enterprises with more than eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related services.

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ment of payments in another jurisdiction is often unclear, and accounting functions are not always coordinated in such a way that it is easy to determine. In unrelated party settings these problems multiply. We would strongly suggest to take these concerns more into consideration.

In addition, we note that the BEPS work on Action 7 and lowering of the PE threshold means there are likely to be a greater number of PEs going forward. Although in reality we expect many of these to be “trading” branches, it could still lead to an additional administrative requirement for businesses that need to undertake work to confirm that there are no mismatches. We strongly encourage the OECD to suggest that substantive trading permanent establishment operations be excluded from counteraction under the branch mismatch rules, in order to ensure that taxpayers do not have to spend significant resources completing assessments of their transactions to ensure that none of them are technically creating a mismatch.

The draft provides that a rule should apply in the case where a payment is deducted but not included in the “ordinary income” of the payee or in another jurisdiction. However, an exact definition of the term “ordinary income” is not provided. It is not clear whether capital gains income should be classified as “ordinary income”. Further, given in most countries taxable profits are calculated from accounting profits, it is unclear how those tax deductions and income inclusions relating to accounting accruals (e.g. fair value movements) ought to be treated and whether they could create mismatch situations. Also, the question of when amounts are subject to tax is not covered in the draft.

Our key concern with the discussion draft is that it is not easy to see how the recommendations could be effectively applied without creating a real risk of double taxation and placing a significant burden on business to determine where the rules will apply. The draft appears to envisage implementation through complex changes to domestic laws, but the interaction of these changes with treaties is not explored. Without treaty changes, it is difficult to see how changes to domestic law alone can ensure these rules work in practice without the risk of double taxation. Countries should not be encouraged to attempt to override their treaty obligations through domestic law changes.

Moreover, the recommended solutions under the discussion draft should be coordinated with solutions proposed elsewhere (e. g. Action 6) so that countries are not led to trigger multiple countermeasures to the same problem. Again, that would dramatically increase the risk of double taxation.

The proposals are, in effect, anti-avoidance rules, but the avoidance takes place in another state. While the mismatch may be an unintended consequence of the interaction of different jurisdictions’ tax rules, in other cases it may be the result of an intentional policy decision, such as an investment incentive or specifically targeted deduction. The proposed recommendations run a risk of undermining domestic policies that may be based on fiscal, economic and political considerations. We suggest that the rules should be narrowed in scope to avoid this.

The discussion draft is also silent on partnerships. Although they may be less likely to be structured into, it would be useful to have some guidance on this as in these cases it will be more difficult to ascertain the other party's tax treatment of a transaction.

Aligning the tax impact of cross-border transactions involves inherent complexity. Although complexity should not be a barrier to action, the recommendations should not come at the price of undue uncertainty and the compliance obligation placed on business should be kept to the necessary minimum. Even if implemented in a coordinated manner, the complexity of the proposed rules will create substantial compliance difficulties both for taxpayers and tax administrations, and will complicate the allocation of taxing rights between jurisdictions, increasing the risk of double taxation.

Please do not hesitate to contact us if you have any questions.

Sincerely,

Berthold Welling　　　　Dr. Karoline Kampermann

September 19, 2016

BEPS Action 2: Branch Mismatch Structures

Comments by the Banking and Finance Company Working Group on BEPS

I. Introduction

These comments are being submitted to the OECD by the Banking and Finance Company Working Group (the "Working Group") on Base Erosion and Profit Shifting (BEPS)[1] in response to the public Discussion Draft released on 22 August 2016 by the OECD entitled BEPS Action 2: Branch Mismatch Structures (the "Draft"). We note the unusually short time between publication of the Draft and the deadline for comments, and therefore would welcome the opportunity both to engage in a more detailed discussion with the OECD beyond this submission in order to highlight specific examples that may support these comments and to explore further the solutions that could address the concerns set out below.

The Draft discusses a number of potential recommendations for the treatment of branches, each of which seeks to counteract the ability of taxpayers to create perceived BEPS risk through the utilization of branch structures that may replicate tax mismatches addressed by the recommendations contained in the Final Report on Neutralizing the Effects of Hybrids Mismatch Arrangements (the "Action 2 Report") issued last October.

The Draft does not, however, address the differences between a credit and exemption system of taxation. For example, if the residence country (e.g. the United States) taxes all of the income of the branch on the basis of worldwide taxation, and provides a credit for foreign taxes paid by the branch, the recommendations in the Draft should not apply. Moreover, the Draft fails to consider how any of the proposals might interact with a worldwide system of taxation that includes controlled foreign corporation (CFC) rules, rules that would deny duplicative losses, and interest allocation rules when there is effectively connected income.

Furthermore, it is difficult to determine how the recommendations would work in connection with existing tax treaty obligations.

Aside from these fundamental concerns with the Draft, the recommendations in the Draft would significantly impact banking groups[2] , which is the focus of this submission. Given the prevalence of

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[1] The Banking and Finance Company Working Group comprises members of the Securities Industry and Financial Markets Association (including Citigroup, T.D. Bank, JPMorgan Chase & Co., Bank of America, Jefferies, Credit Suisse and Goldman Sachs), and Barclays and American Express. The Securities Industry and Financial Markets Association (SIFMA) is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raise over $2.5 trillion for businesses and municipalities in the U.S., serve clients with over $20 trillion in assets and manage more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

[2] When this submission refers to the "banking group," "banking industry," or "banks and other similarly regulated financial services groups," we are referring to banks, broker dealers, investment banks and finance company groups that are regulated by an independent prudential regulator typically established by statute, or a subgroup of a larger business that is regulated as such and that includes financial services entities that are regulated as well by a local regulator (referred to as solo-regulated). These group and subgroups also include entities that are not

true branches (i.e., branches whose existence and substance is recognized both in the country where the branch is located and in the enterprise's home country) in many multinational banking groups for regulatory and (non-tax) commercial reasons, through which these groups conduct their main operating activities, the Working Group is particularly interested in ensuring that the OECD's efforts in this area are appropriately targeted and do not result in the disallowance of deductions incurred in the ordinary course of business activities in a true branch; and further, do not create tax compliance and administrative issues for ordinary-course transactions between a banking branch and a head office. As described in more detail below, we believe the Draft would create such problems. Accordingly, we urge the OECD to further tailor its work in this area in order to avoid unnecessarily applying the recommended approaches in the Draft to ordinary-course transactions as part of regulated financial services groups.

II. Background on bank branches

It is important to understand that banks have traditionally conducted their global operations in branch form, although most banking groups today contain a combination of branch operations and subsidiaries. These are true branches, not disregarded entities. Branches remain more prevalent for this regulated industry than in any other industry, for example as a result of capital-efficiency opportunities and/or "passporting" of financial services into other jurisdictions.

Generally, bank regulators in each jurisdiction would require an amount of regulatory capital, which in the aggregate could greatly exceed the regulatory capital of the entity of which these branches are a part, and which may be less easily reallocated as activities change over time. Thus, operating through a branch network allows a bank to utilize its capital more efficiently than may be the case when operating separate bank corporations.

In addition, branches have not generally been required by local country regulators to maintain their own capital to support their banking operations, and instead have been able to rely on the capital of the head office entity itself. Historically, local regulators have accepted the branch form of doing business, confident that a strong home country prudential regulator would be sufficient to protect the interests of local customers even as the business expanded lending and other activities within the local country. Furthermore, the capital and liquidity resources of the head-office entity are generally much greater than that of the capital and liquidity resources of a local subsidiary, thereby providing a safer operating environment for branch activities. Therefore, operating as a branch of a global bank has served the purpose of increasing the safety and soundness of the banking operations in that country from the standpoint of the local country regulator, a feature of operating in branch form that is also attractive to customers.

Furthermore, under EU directives, and extended to the European Economic Area (EEA), a bank or insurer in one member state is able to do business using branches in other member states due to the concept of regulatory passporting.

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subject to local regulation but are integral to the financial services group or subgroup that is subject to consolidated regulation, such as holding companies and services companies.

III. The Draft and its potential application to banking branches

In our view, some of the proposals contained in the Draft fail to recognize fundamental differences between conducting business through a separate entity and through a branch, and the way in which entities operating through a branch are taxed in their territory of residence. In particular, we have fundamental concerns with the basic premise that the recommendations contained in the Action 2 Report are required to be, and are capable of being, translated across to the recommendations in Sections 2 and 3 of the Draft (diverted branch payments and deemed branch payments).

We note that the overall objective of Action 2, in accordance with the final Action 2 Report, is to encourage the adoption of rules that neutralize hybrid mismatches because by neutralizing the mismatch in tax outcomes, the rules will prevent these arrangements from being used. In other words the objective of the Action 2 work is to create a deterrent in relation to certain categories of multinational tax planning. If the project is successful, hybrid entities and hybrid instruments will simply not be created, and the rules will not actually be applied in practice. In contrast, branches will continue to exist for banks, and dealings between branch and head office will also continue in large volume. Therefore, if not carefully drafted, in contrast to the overall Action 2 policy objective there is a danger that any rules relevant to branches will have to be applied to a large volume of transactions in practice in order to determine whether a counteraction is required – when the taxation of those transactions is not in reality giving rise to a hybrid mismatch equivalent to those addressed by the Action 2 Report.

In particular, we are concerned that the Draft could cause banks with overseas branches to suffer a restriction or imputation on entirely normal trading situations, where there is no avoidance in the context of the BEPS Action 2 policy objectives.

We also have concerns about the practical application of the recommendations in relation to both deemed branch payments and so-called double deduction (DD) branch payments.

Separately, we note that the OECD has previously undertaken significant work in relation to the attribution of profits to permanent establishments, particularly with respect to banks and enterprises conducting a global trading business, which culminated in the 2010 Report on the Attribution of Profits to Permanent Establishments (the "2010 Report"). The 2010 report included recommendations for the methodologies to be adopted for the proper determination of permanent establishments' profits for tax purposes. We note that some member countries of the OECD have implemented these recommendations and some have not. Even where two countries have broadly implemented the recommendations, the practical application to particular fact patterns may differ. The practical experience of the Working Group is that some differences inevitably arise between the head office and permanent establishment tax jurisdictions' treatment of transactions involving permanent establishments and branches, particularly in relation to a complex operating business such as banking. Nonetheless, it is expected that such differences do not affect the view that in essence the two jurisdictions identify broadly the same taxable profit in the branch. Further, any such differences will not necessarily be in the taxpayer's favor given that they simply reflect the application of the relevant permanent establishment tax rules to the commercial transactions undertaken. We would suggest, however, that the primary question to be considered by the OECD at this point is in relation to the level of adoption of the recommendations in the 2010 Report, and/or the greater use of existing mutual agreement procedures between head office and permanent establishment jurisdictions. If the lack of harmonization in approach to profit attribution amongst OECD countries is found to be a matter of concern, we would suggest that it is not appropriate for this concern to be addressed through BEPS Action 2.

To the extent that such differences are regarded as mismatches, as the Draft seems to propose, they are "accidental mismatches" in relation to complex operating businesses, and we would suggest that these should not give rise to policy concerns in the context of Action 2. A set of proposals that seek to eliminate any mismatch, no matter how small and whether tax-motivated or not, would be entirely disproportionate in its impact in terms of complexity and compliance burden to the risk it purportedly would address. The Working Group believes that this disproportionate burden would fall hardest on the banking sector.

We believe that a different approach could be taken that focuses on transactions that are intended to take advantage of deemed or artificial branch arrangements to produce inappropriate tax results. This would then deliver the same desired policy outcome as the final Action 2 Report, in that the hybrid arrangements will simply not be created – while also ensuring that there is not an adverse impact on normal operating branch activity. We have provided explanations of this in the course of our comments below, and provided some specific suggestions in our Conclusion. We would be pleased to elaborate on these and to discuss the approach further with the OECD.

We turn to the specific aspects of the Draft that present the greatest concerns to the Working Group.

IV. Diverted branch payments

It is possible that payments that are characterized as "diverted branch payments" may occur in the ordinary course of a banking business. The Working Group considers, however, that the recommended approach in the Draft to counteract those ordinary-course payments, while not identifying and addressing the root cause (being the inconsistent international practices in relation to the attribution of profits to permanent establishments) is disproportionate and inappropriate.

Suppose, for example, that A Co is a bank resident in a jurisdiction that applies an exemption in relation to overseas permanent establishments, including its operating branches, such as B Branch. A question could arise in relation to every payment made to B Branch whether the full amount of the payment is brought into account by the branch, and where that is true, whether this accords with the measure of branch profits for the purpose of determining the amount of A Co's profits that are exempt under the law of jurisdiction A because they are seen as attributable to B Branch. Such payments could be received from third parties or, in the context of a global banking group, from related parties.

Due to the complexity of the business and the lack of harmonization of international principles and practices for attribution of profits to permanent establishments, it is possible that some payments to A Co incurred in the ordinary course of its business could be regarded as:

a) In both jurisdiction A and B as attributable to B Branch
b) In jurisdiction A as attributable to the head office in A, and in jurisdiction B as attributable to B Branch (resulting in double taxation), or
c) In jurisdiction A as attributable to B Branch and in jurisdiction B as attributable to the head office in A.

In the experience of the Working Group, (a) is hoped for and is usually the case, (c) is possible but rare in practice and not possible to plan for, while (b) is unfortunately commonly observed in the real world.

This could be due to differences in rules between jurisdictions or differences in view regarding where the Key Entrepreneurial Risk Taking functions reside.

Therefore, the Working Group believes a rule that counteracts situations such as (c) occurring in the ordinary course of a banking business, while it would not address fundamental issues of lack of harmonization of international principles and practices for attribution of profits to permanent establishments would be disproportionate and inappropriate.

V. Deemed branch payments

We consider that the policy recommendations described in Section 3 of the Draft relating to "deemed branch payments" appear to determine that a hybrid mismatch arises in situations that should fundamentally be viewed as a question of potential misalignment of profit allocation between the head office and branch jurisdictions. The OECD should therefore address this as a question of lack of international alignment in relation to the attribution of profits to permanent establishments, rather than a matter for BEPS Action 2.

We understand that the Draft assumes that the incidence of deemed branch payments is considered unusual, and therefore may commonly be associated with tax planning. In the banking sector this is not the case. Such payments occur frequently and in large volumes. This is because in most jurisdictions the measure of taxable profits of a banking branch is based on a measure of the branch profits in accordance with the branch "books," and these "books" will commonly reflect "transactions" between the branch and the head office (which are by definition "deemed" transactions as they relate to dealings within the same legal entity). These could include funding or financial trading transactions (in high volume), or the provision of services. While the question of taxable branch profits is ultimately an issue of allocation of a legal entity's profits, the way in which the calculation is carried out in practice for banking branches commonly reflects a large volume of tax-deductible deemed payments from branch to head office.

Examples

1) For example, suppose Bank A in jurisdiction A has an operating branch B in jurisdiction B. Suppose that the functional currency of Bank A for the tax purposes of jurisdiction A is EUR, and that the functional currency of Branch B for the tax purposes of jurisdiction B is CHF. Suppose that the "books" of the branch reflect a EUR:CHF derivative booked between the branch and head office, which hedges EUR assets held by Branch B, under which payments are made from branch to head office. Bank A does not enter into any "market" EUR:CHF derivative as it is hedged from a EUR perspective, and therefore the payments under the derivative are not an allocation of an external cost. Payments under the derivative may be deductible in jurisdiction B but ignored in jurisdiction A when jurisdiction A is determining what proportion of the (EUR) profits of Bank A are attributable to Branch B.

2) Branch B makes a 5-year fixed rate loan to a customer, but the majority of its third party funding is at floating rates. Branch B therefore books a fixed/floating 5-year interest rate swap with the head office. Bank A has a wide range of third party interest rate exposures of fixed and floating nature, across a wide range of maturities, both in terms of its borrowings and assets. Bank A assesses its interest rate exposure in the round and concludes it does not need to enter into a specific external hedging transaction to correspond to the derivative booked with the branch (in essence the bank as a whole is hedged against the 5-year fixed-rate interest exposure arising from the loans extended by the branch). Jurisdiction B may *allow deductions for payments under the interest rate swap, but jurisdiction A may not bring such payments into account for tax purposes.*

The proposed rules in the Draft could therefore potentially apply to a large volume of such payments that occur in the ordinary course of a banking business and not as a result of tax planning in the context of BEPS.

There is a fundamental difference between the situations discussed in the Action 2 Report and those that appear to be within the scope of the recommendations discussed in Section 3 of the Draft. The Action 2 report, and the other types of situations addressed in the Draft, are concerned with actual payments between different entities and are specifically excluded from applying to payments that are deemed to arise for tax purposes. By contrast, section 3 is concerned solely with deemed payments which have no actual legal existence.

The “deemed” payments with which Section 3 is concerned are fundamentally allocations of profit. This distinction is illustrated where the Draft attempts to apply the concept of “ordinary income” in this context. We believe this gives rise to a fundamental definitional problem. Paragraph 32 of the Draft recommends that the deemed branch payment rule would apply in circumstances where *“a notional or deemed payment between the branch and the head office which was deductible under the laws of one jurisdiction (the payer jurisdiction)* ***but not included in ordinary income*** *under the laws of the other jurisdiction (a D/NI outcome).”*

We note that the definition of ordinary income in the Action 2 Report at paragraph 32 is as follows: “*Ordinary income refers to those categories of income that are subject to tax at the taxpayer’s full marginal rate and that do not benefit from any exemption, exclusion, credit or other tax relief applicable to particular types of payments.”*

However, we believe that deemed (or real) payments between a branch and head office are under many tax systems incapable of ever meeting the definition of ordinary income as set out above:

- Where the head office operates in a country that taxes on a worldwide basis with a credit system in relation to foreign permanent establishments, such transactions are ignored in determining taxable income, and therefore cannot give rise to ordinary income. While there would be a question whether such “transactions” are respected for double tax relief purposes in determining the credit available against the (worldwide) income of the entity, this is a separate question from the question of ordinary income.
- Where the head office operates an exemption system in relation to foreign branches, even where such a payment is respected in the head office measure of exempt branch profits, the effect may result in that payment reducing the measure of how much of the entity’s profits are exempt branch profits. Our concern is that, depending upon the precise mechanism for the exemption system, this may not be the same as the payment giving rise to “ordinary income” as defined in the draft Action 2 Report, being a negation of an exemption rather than income per se.

We assume that the concern articulated in the Draft is directed towards situations where the head office tax jurisdiction and permanent establishment tax jurisdiction’s views are fundamentally misaligned in relation to whether the notional/deemed payment is properly attributable to the permanent establishment. We would therefore suggest that the Action 2 Report's concept of ordinary income is an inappropriate concept with which to define this concern.

Nevertheless, as articulated above, in the real world there can be differences in the treatment and/or measurement of deemed payments for tax purposes between branches and head offices when considering the normal operating business of the branch, though such differences presumably do not affect the view that in essence the two jurisdictions identify broadly the same taxable profit in the branch. This is due to the lack of full alignment between different jurisdictions' principles and practices for measuring taxable profits of branches, even where both broadly follow the Authorized OECD Approach (AOA). This misalignment may result in incidental instances of double taxation or non-taxation. In the context of ordinary-course dealings of banking branches, such differences -- even if capable of being detected -- do not result from tax planning and do not represent BEPS.

Again, we would suggest that addressing the "root cause" of such mismatches arising from normal commercial operations, being a degree of misalignment in profit attribution practices globally, would be a far more appropriate way to address concerns regarding mismatches than the proposals in the Draft, which will create a disproportionate and inappropriate impact on the banking sector and will only address such operating differences in one direction, i.e. to the taxpayer's detriment.

There may also be additional concerns in relation to the recommendation that the rule applies where the deemed deduction is eligible to be offset against non-dual inclusion income. We have explained our concerns in relation to the approach taken on dual inclusion income in our comments on DD branch payments below, but for the most part these are also relevant in the context of deemed branch payments.

VI. DD branch payments

The Working Group is also concerned with the DD branch payments proposals, in particular on the practical question of ensuring that such payments cannot be deducted against income other than dual inclusion income.

Many of the world's largest banks are parented in jurisdictions that operate a worldwide tax with credit system in relation to foreign branches (e.g. the U.S., Japan, the United Kingdom). Under such jurisdictions, DD outcomes are the norm in relation to payments made by branches. This is a well understood feature of the tax systems of such jurisdictions. During the financial crisis, where many banks made losses globally, the result was that deductions and resulting losses were commonly available both in local branch jurisdictions and in the head office jurisdiction. As profits are made subsequently in branch jurisdictions, the double deduction may naturally be clawed back through double taxation of such profits. This means that DD outcomes in these circumstances are an expected part of a coherent worldwide tax with credit system.

We recognize the risk identified where a deduction is actually exported out of the closed system of head office and branch and offset against income of another entity. We are concerned, however, that the requirement in practice to prove that DD outcomes only allow deductions against dual inclusion income is not sufficiently focused on the policy concern and could again represent a significant burden in practice on the banking industry in circumstances where there is no BEPS. We would be concerned if this required the granular identification of every item of income associated with the branch to determine whether it is brought into account in both head office and branch jurisdiction, which is unlikely to be practical in relation to the ordinary-course transactions of an operating branch. Again, given the lack of full global alignment in practices for attributing profits to branches, it is possible that there may be some instances of items of income that are not dual inclusion income, though such differences do not affect the view that in essence the two jurisdictions identify broadly the same taxable profit in the branch. We would suggest, however, that restricting deductions being taken against such items -- and the associated compliance burden in order to identify them -- would not be commensurate responses to the risks identified.

The requirement for offset against dual inclusion income also creates problems where the branch is in a net loss position. Again, we believe it is appropriate that the branch expenses remain available for offset against profits in the head office jurisdiction under a worldwide basis of taxation, where a deduction is not actually exported out of the closed system of head office and branch such that it is offset against income of another entity.

VII. Conclusion

We have fundamental concerns with the Draft, in particular because it fails to address such key issues as the differences between a credit and exemption system of taxation, and how the recommendations would work with existing tax treaties. Aside from those concerns, the Draft should distinguish between the use of true operating branches, prevalent in the banking sector, and deemed or artificial branches that are structured to produce inappropriate tax results. As noted above, regulated financial services companies often operate in branch form for reasons unrelated to tax.

For the reasons stated above, we urge a more considered approach with respect to the banking sector given the disproportionate impact that would occur under the Draft's proposals. We suggest that to the extent the proposals are taken forward, it would be appropriate either:

- For the final recommendations to exclude the application of the rules to transactions occurring in the ordinary course of operating true branches of regulated financial businesses, and/or
- To achieve the deterrent objective aligned with the broader Action 2 context, for the rules only to apply to structured arrangements designed to produce mismatches, specifically including in this case a structured arrangement within a legal entity, in order to both deter such structuring from arising in the first place and ensure that there are not adverse consequences due to any minor differences in determining branch profits from genuine operating activities.

The **BEPS** Monitoring Group

Comments on the Public Discussion Draft on

BEPS ACTION 2 BRANCH MISMATCH STRUCTURES

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Jeffery Kadet, with contributions and comments from Sol Picciotto and Tommaso Faccio.

GENERAL REMARKS

1. In our comments on the Action 2 proposals over two years ago, we commended the OECD for having produced a technically sophisticated analysis and solutions which were carefully and elegantly designed, but also pointed to their complexity and stressed the need to begin with an overview of the causes of the problems. Rules regarding hybrids are necessary purely because of the insistence on applying the 'separate entity' principle to entities which are under common control, instead of basing the taxation of multinational enterprises (MNEs) on the economic reality that they operate as unitary firms. The separate entity fiction is especially inappropriate when applied to branches, which even legally are not regarded as independent. This creates a strong incentive for MNE tax advisers to devise techniques such as the use of hybrids to exploit this basic flaw. While the sophisticated and complex counter-measures being proposed may patch up the system to some extent, the rules will be ineffective while the basic flaw remains.

2. Our previous comments also stressed that in order to be effective countries should adopt harmonious and coordinated rules, especially in view of the complexity of the issue. The Action 2 Final Report (*Neutralising the Effects of Hybrid Mismatch Arrangements*) summarizes in Annex A the Report's recommendations regarding additions to the domestic law of adopting countries. In particular, paragraph 275 states:

> Although the recommendations in the report are drafted in the form of rules, it is not intended that countries transcribe them directly into domestic law without adjustment. It is expected that the recommendations will be incorporated into domestic tax legislation using existing local law definitions and concepts in a manner that takes into account the existing legislative and tax policy framework.
> …

Paragraph 297 goes on to say:

> The outcome envisaged by the report is that each country will adopt a single set of integrated linking rules that provides for clear and transparent outcomes under the laws of all jurisdictions applying the same rules. The rules must therefore be drafted as simply and clearly as possible so that they can be consistently and easily applied by taxpayers and tax authorities operating in different jurisdictions. This will make it easier for multinationals and other cross-border investors to interpret and apply the hybrid mismatch rules, reducing both compliance costs and transactional risk for taxpayers.

The BMG is not aware if WP11 intends to provide one or more samples of possible statutory and regulatory language that individual countries could use as a base for tailoring local legislation implementing the recommendations issued under the Action 2 Final Report. In any case, given the complicated nature of both the Action 2 recommendations and these additional recommendations concerning branch mismatch structures along with the limited resources and sophisticated capable personnel in many countries, we strongly recommend that one or more samples of such language be produced for use by interested countries.

On a similar note, both the Action 2 Final Report and the discussion draft comment that “countries would be encouraged to identify appropriate implementation solutions that preserve the intended outcomes under these rules while avoiding unnecessary complexity.” (The quoted example is from paragraph 69 of the discussion draft.) We recommend that WP11 develop and provide to interested countries a range of possible implementation solutions.

3. A number of the 25 listed questions ask whether there are any practical issues that could arise in implementing the various recommendations. While we of course agree that practical difficulties will undoubtedly arise, we are seriously concerned that these questions will spawn an avalanche of complaints about innumerable terribly insurmountable issues. It must be remembered that these complaints will be coming from the many MNEs that have spent great time and effort to create and benefit from all sorts of sophisticated mismatches that through artificial means have taken advantage of the uncoordinated taxation systems in both tax havens and the countries in which they actually conduct operations. With this in mind, we very much hope that WP11 members will read the many MNE responses to these questions about practical difficulties and will significantly discount them as appropriate.

4. Footnote 4 on page 10 states, in part: “… countries may consider responding to the problems of non-taxation resulting from potential abuses of the exemption method under Article 23A by not including the exemption article in their treaties.”

Since many treaties will have this Article 23A in their existing networks of treaties, this possible modification of existing treaties should be considered for inclusion in the Action 15 Multilateral Instrument. The BEPS Monitoring Group in its comments submitted on 30 June 2016 suggested a Country Schedule mechanism that would allow countries maintaining bilateral tax treaties to agree on specific changes. See “Amending Existing Bilateral Treaties: Country Schedules” beginning on page 3 of this 30 June 2016 BEPS Monitoring Group submission.

RESPONSES TO SPECIFIC QUESTIONS

1. Are there any practical issues that could arise in denying the benefit of the branch exemption for a payment that is disregarded, exempt or excluded from taxation under the laws of the branch jurisdiction?

Response:

None noted.

2. Are there any practical differences between reverse hybrids, on the one hand, and disregarded branch and diverted branch payment structures, on the other, that would justify a different approach to that set out in Chapters 4 and 5 of the Action 2 Report?

Response:

None noted.

3. Should the branch payee mismatch rule apply only to payments made under a structured arrangement or between members of the same control group?

Response:

We agree that the branch payee mismatch rule should only apply to payments made under a structured arrangement or between members of the same control group. The broad definition of “structured arrangement” provided in paragraph 19 should include coverage of any payers that have entered into transaction forms with the expectation of some amount of economic benefit from inappropriate payee tax effects. Given, though, that a payer’s intention is particularly difficult for the payer’s tax authority to know, in any case where the payer’s tax authority becomes aware of a payee having used a D/NI arrangement, the burden of proof that there is no structured arrangement must be on the payer.

4. Are there any practical differences between hybrid entities and deemed branches and diverted branch payments that would justify modifying the scope of the rule or the guidance on the application of the structured arrangement rule to these types of branch mismatches?

Response:

None noted.

5. Do the above paragraphs provide a clear explanation of the intended interaction between the branch payee mismatch rule and the ordinary rules for allocating income to a branch (including any rules consistent with those set out in Section 2.3 limiting the scope of the branch exemption)?

Response:

Yes, we believe that this discussion draft provides a sufficiently clear explanation.

6. Should a payment to a branch be treated as included in income for the purposes of the disregarded branch or diverted branch payment rules if the payment is taken into account under the CFC rules in the parent jurisdiction?

Response:

We agree that a payment to a branch in regard to the disregarded branch or diverted branch payment rules should take into account whether the payment has been subjected to tax through the CFC rules in the parent jurisdiction. Three additional points, though, must be made.

First, with the tax authority of the country of the payer having little ability to be aware of or understand the CFC rules applicable to the ultimate parent company, it must be clear that the burden of proof is on the payer to establish to its tax authority that the CFC rules of the ultimate parent of the payee have adequately operated to ensure taxability of the payment at issue.

Second, it must be made clear that this CFC exception will only apply where the payment has been included in the parent's ordinary income and actually subjected to tax at the full rate. Anything less than full current taxability will invite and motivate BEPS planning. For example, this CFC exception should not apply where there are existing net operating losses or offsetting credits from excess foreign tax credits or other benefits available at the parent level that prevent a full additional tax on the income recognized under the CFC rules.

Third, with the continued reduction of tax rates in various countries (the U.K. is a good example of this), there will be strong motivation to construct mismatches involving two high-tax countries where the home country has a lower rate. Thus, for example, say that the branch payee mismatch happens between Italy and the US (tax rates > 30%) and the ultimate parent company is in the U.K. with its lower rate. There must be clarification that CFC rules in the parent's country in cases like this will not override and be treated as neutralizing the mismatch that has occurred between the two higher tax countries.

7. Do the paragraphs above provide a clear explanation of when a disregarded branch and diverted branch payment will be treated as having given rise to a mismatch in tax outcomes?

Response:

We believe the paragraphs provide an adequate explanation.

8. What is the appropriate legal test for determining whether a payment made under a branch payee structure has given rise to a branch mismatch?

Response:

We do not see any specific "legal test". Rather, we see a simple factual test. Unless a payment qualifies for an exception (e.g. application of the CFC rule) for which the payer meets his burden of proof, the branch payee mismatch rule would apply to any payment that is factually not included in the income of the payee's residence jurisdiction or the host jurisdiction of the branch.

9. What other guidance (if any) is required to explain the intended scope of the branch payee mismatch rule.

Response:

We wish to reiterate that with the informational disadvantage of the tax authority in the country of the payer, it is particularly important to make clear that the burden of proof is on the payer with respect to any claim that there is no "structured arrangement" or that a payment qualifies for an exception (e.g. CFC exception or tax exempt status in country of residence).

This informational disadvantage suggests additional points of guidance to tax authorities in the country of payers. To put payers on notice that they must be aware of the tax status of their payees, guidance should be provided on two matters.

First, for all payments that are made either to a branch of a related party or to any bank account of a related party where that account is located outside the country of residence of the related party, there is a presumption that the branch payee mismatch rule will apply to disallow a deduction. The same presumption will apply for any payment that is a part of any "structured arrangement". For all such payments, the burden of proof is on the payer to overcome the presumption.

Second, there should be added to local tax returns or other relevant filings a question that must be answered stating that the payer has confirmed with all applicable payees (i.e. all related party recipients and all payees in structured arrangements) that relevant payments have been reflected in income in either the payee's country of residence or country of the branch. In the absence of such confirmation, relevant payments would be disallowed as deductions until the payer meets the burden of proof required to overcome the above presumption.

10. Are there any practical differences between disregarded hybrid payments, on the one hand, and deemed branch payments on the other that would justify a different approach to that set out in Chapter 3 of the Action 2 Report?

Response:

None noted.

11. Are there any practical issues that could arise in applying the branch mismatch rules to a deemed payment between the branch and head office?

Response:

None noted.

12. Do you agree that a payment that is treated (for tax purposes) as made between the branch and head office but which, in practice, results in an allocation of third party expenses should be outside the scope of the deemed branch payment rule?

Response:

Yes, we agree that such a payment should be outside the scope of the deemed branch payment rule. We believe that the example discussed in paragraphs 39-45 clearly shows that only 50 of the notional payment and not the full 55 is outside the scope so that 5 of the notional interest expense would be caught by the deemed branch payment rule.

13. Do you agree that payments that represent or are calculated by reference to a third party expense should fall within the scope of the DD branch payment rules discussed in Section 4 below?

Response:

Yes, payments that represent or are calculated by reference to a third party expense must fall within the scope of the DD branch payment rules discussed in Section 4.

14. Is it practical to distinguish between deemed and DD branch payments based on whether the notional payment is treated as an allocation of a third party expense by the taxpayer?

Response:

We believe that it is practical. The burden of proof must, of course, be on the taxpayer to demonstrate that third party expenses have been incurred and have been allocated on an acceptable and supportable basis.

15. Do you agree that no mismatch arises (and no adjustment should be required) under the deemed branch payment rule if the rules in the branch or residence jurisdiction operate in such a way as to ensure that the total amount of the taxpayer's income will be brought into account in at least one jurisdiction?

Response:

We agree that no mismatch should arise (and no adjustment should be required) under the deemed branch payment rule if the rules in the branch or residence jurisdiction operate in such a way as to ensure that the total amount of the taxpayer's income will be brought into account in at least one jurisdiction. The example in paragraph 48 shows this well.

16. Are there any practical difficulties in determining the amount of dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

Response:

None noted.

17. Is further guidance required on the circumstances when the deemed branch payment rule should apply?

Response:

None noted.

18. Do you agree that the primary rule in respect of deemed branch payments should be to deny the deduction in the jurisdiction where the payment is deemed to be made?

Response:

Yes, we agree that the primary rule in respect of deemed branch payments should be to deny the deduction in the jurisdiction where the payment is deemed to be made

19. What further guidance (if any) is required on implementation solutions for the identification of dual inclusion income in the context of these branch mismatch arrangements?

Response:

None noted.

20. Do you agree that a secondary or defensive rule is required to address any mismatch in tax outcomes that could otherwise arise where the payer jurisdiction does not apply the primary rule?

Response:

We agree that the secondary or defensive rule recommended in this discussion draft is absolutely required. To not have such a rule would motivate continued BEPS planning and structures.

21. Do you agree that although these branch mismatch structures may not be thought of as "hybrid" they still fall within Recommendation 6 of the Action 2 Report and would be subject to adjustment under those rules?

Response:

Yes, we agree that these branch mismatch structures clearly fall within paragraph 2(a) of Recommendation 6 of the Action 2 Report and would be subject to adjustment under those rules.

We note that the application of the primary response and defensive rules result in a different final allocation of profits in Country A and Country B than would have been the case had Country B not applied a tracing approach to the interest expense. This difference could be exploited for BEPS purposes where the corporate tax rates of Country A and Country B are different. While we do not have any specific suggestion to eliminate this potential for BEPS exploitation, WP11 could consider whether there is additional guidance that could be provided to address this potential exploitation.

There is an informational disadvantage of the tax authority in Country B in this sort of branch mismatch structure since that tax authority will have no practical way of knowing whether a second deduction is being allowed in Country A against non-dual inclusion income.

This being the case, for all payments not directly made by the branch (e.g. payments made by the head office that are accounted for as branch expenses through tracing concepts, through allocation, etc.), there is a presumption that the defensive rule will apply to disallow a deduction in the Country B tax calculation. The burden of proof is on the taxpayer to overcome the presumption.

It is particularly important to make clear that this burden of proof is on the taxpayer to inform the Country B authorities if an amount is subject to these rules and has been or has not been disallowed as a deduction under the primary response in Country A. The local return or other relevant filings in Country B should include a question that must be answered stating that any expenses for which a deduction is given in the country of the branch has not also been treated as a deduction in the country of residence, or alternatively that any such deduction is against dual inclusion income. In the absence of such confirmation, the expense would be disallowed as a deduction in Country B until the taxpayer meets the burden of proof required to overcome the above presumption.

22. Are there any practical difficulties in determining the amount of duplicate deductions and dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

Response:

None noted.

23. Is further guidance required on the circumstances when Recommendation 6 should apply to DD branch payments?

Response:

None noted.

24. Should the imported branch mismatch rules apply only to payments made under a structured arrangement or between members of the same control group?

Response:

Yes, the imported branch mismatch rules should apply only to payments made under a structured arrangement or between members of the same control group. Also see relevant comments made above in the response to questions 3, 6, 8, and 9.

25. Are there any practical differences between branch and imported mismatches that would justify modifying or clarifying the scope of the rule or the guidance on the application of the imported mismatch rule?

Response:

None noted.

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September 19, 2016

Ref: DISCUSSION DRAFT: BEPS ACTION 2 – "BRANCH MISMATCH STRUCTURES"

Dear Achim,

Thank you for the opportunity to comment on the Discussion Draft: BEPS Action 2 – Branch Mismatch Structures issued on 22 August 2016 ("the Discussion Draft"). We recognise and thank the OECD for the time and effort put into this draft.

BIAC has always acknowledged that some hybrid transactions can lead to exactly the base erosion and, in some cases, double non-taxation, that the G20 leaders identified as requiring action. Branch mismatch arrangements do not always result from differences in the tax treatment of an instrument or entity and so are not straightforwardly "hybrid" but in some circumstances can lead to similar outcomes as the result of differences in allocating income and expenses between a branch and head office jurisdiction. BIAC believes, however, it is important that it is recognised that the vast majority of branches, and transactions undertaken by branches, are not "planned" to gain a tax benefit, and that in the vast majority of cases those instances which the Discussion Draft may be describing as branch mismatches are simply a feature of how the tax rules in different jurisdictions interact.

In addition, we note that a significantly increased number of "new" permanent establishments are anticipated as the BEPS Action 7 proposals are implemented. Accordingly (i) the administrative burden of complying with these rules, and (ii) exactly how profits and losses will be allocated between head offices and permanent establishments (and any mismatch implications of this) will be extremely complex, and is, currently, somewhat unclear.

The Discussion Draft addresses comprehensively the types of branch structures that could lead to mismatches. However, the recommendations to remedy these mismatches are not as thoroughly developed. Our key concern with this draft is that it is not easy to see how the recommendations could be effectively applied without creating a real risk of double taxation (for example where one of the counterparties operates in a country with a worldwide -- as opposed to territorial -- tax system), and placing a significant burden on business to determine where the rules will apply. The interaction of these proposals with international and other domestic rules will also be very complex. BIAC hopes that WP11 will acknowledge these concerns, and we stand ready to help the WP refine these rules so that they are proportional and workable.

Again, we thank you for the opportunity to comment on the Discussion Draft.

Sincerely,

Will Morris

Will Morris, Chair
BIAC Tax Committee

Introductory Comments

1. BIAC advocates strongly for pro-growth tax systems which facilitate cross-border trade and investment, enhancing economic growth and efficiencies in the international market place. Cross-border trade and investment must be supported by pragmatic and workable international and domestic rules which clarify which jurisdiction has the right to tax income and ensure therefore that income is not subject to double taxation.
2. The OECD/G20 BEPS project aims to ensure that gaps and mismatches in tax rules cannot lead to the artificial shifting of profits to low or no-tax locations. BIAC fully understands that there is a concern that certain mismatches between countries can lead to instances of double non-taxation and that additional rules may be required to support the hybrid recommendations included in the Final Action 2 Report released in October 2015.
3. The Discussion Draft is comprehensive in identifying the branch structures that would lead to mismatches. However, the recommendations to remedy such mismatches are not as comprehensive and BIAC has serious concerns about the difficulty of applying them in practice and the corresponding risk of double taxation. The guidance in the Final Action 2 Report comprised 15 chapters and two annexes and addressed in detail the complex issues that will arise in the implementation of the anti-hybrid rules in domestic law and treaties. It is not clear whether the OECD intends to provide a similar level of detail to deal with the even more complex issues and interactions that arise from extending the principles of the Action 2 report to branch mismatch structures.
4. While BIAC does not defend hybrid mismatches, or the branch mismatches identified as a cause of BEPS in this draft, as a general policy matter, we remain concerned about both the Final Action 2 Report and the Discussion Draft. Although the bulk of this response will be focused on the Discussion Draft many of our general points apply also to the recommendations under the Final Action 2 Report.
5. The vast majority of branches are not planned into for tax purposes, and the vast majority of cases those instances which the Discussion Draft may be describing as branch mismatches are simply a feature of how different jurisdictions' tax rules interact. Whether branches actually create mismatches is itself something which is not straightforward to identify. Even in related party situations, the tax treatment of payments in another jurisdiction is often unclear, and accounting functions are not always coordinated in such a way that it is easy to determine. In unrelated party settings these problems multiply. We would request that these recommendations be drafted to be more realistic about this difficulty, and provide solutions that are workable for taxpayers.
6. It is not clear exactly which countries will choose to implement any or all of the recommendations, when they plan to do so, or how the interaction with the local legislative processes will result in differences between countries in terms of application or timing. The draft appears to envisage implementation through complex changes to domestic laws, but the interaction of these changes with treaties and worldwide tax systems is not explored. If this is not more thoroughly addressed by the OECD there will be an increase in tax uncertainty for business and a risk of double taxation and subsequent disputes between countries.

7. Aligning the tax impact of cross-border transactions involves inherent complexity. Although complexity should not be a barrier to action, the recommendations should not come at the price of undue uncertainty and the compliance obligation placed on business should be kept to the necessary minimum. Even if implemented in a coordinated manner, the complexity of the proposed rules will create substantial compliance difficulties both for taxpayers and tax administrations, and will complicate the allocation of taxing rights between jurisdictions, increasing the risk of double taxation.

8. Sectors such as financial services, and oil and gas will be particularly impacted by these rules as they typically conduct various parts of their operations through branches (for non-tax, commercial and regulatory reasons) than other sectors. Financial services businesses are already facing uncertainty and increased difficulty in applying international tax rules, as a result of the Action 2 recommendations on hybrids, the current lack of final Action 4 recommendations in respect of the sector, as well as the interaction of tax rules with other regulatory requirements they face.

Detailed comments

Interaction with worldwide foreign tax credit system

9. The Action 2 Final Report on Hybrids did not consider in sufficient detail how the recommendations would interact with worldwide/foreign tax credit systems.

10. The treaty section of the Action 2 Final Report also raises issues concerning the interaction of the hybrid rules with worldwide/foreign tax credit systems. Paragraph 446 in Chapter 15 of the Action 2 Final Report provides that: "double non-taxation situations may arise in the application of the credit method by reasons of treaty or domestic law provisions that either supplement, or depart from, the basic approach of Article 23 B (Credit Method) of the OECD Model Tax Convention (OECD, 2014). One example would be domestic law provisions that allow the foreign tax credit applicable to one item of to be used against the State of residence's tax payable on another item of income."

11. A number of countries do not follow the OECD Model Treaty approach in Article 23B, notably the US. That approach is at best a "per country" approach and possibly could be read as an item-by-item approach, which is incompatible for countries that operate a worldwide foreign tax credit system.

12. A foreign tax credit system will generally result in less overall untaxed income. Countries with foreign tax credit systems need to balance the potential for cross-crediting with the administrative burden imposed by very restrictive foreign tax credit rules. Similarly, if countries have a sovereign right to choose an exemption/ territorial system, then they may also appropriately choose a worldwide credit even though that might permit some cross-crediting of taxes from a high-tax jurisdiction against income earned in a low-tax jurisdiction.

13. There are a range of reasonable choices from which sovereign countries may choose a method to eliminate double taxation and they should not need to choose the narrowest option. We do not consider that it is appropriate for the branch mismatch rules to imply that a foreign tax

credit system must operate on country by country basis, (rather than, for example, allowing pooling of countries' profits/losses and taxes paid).

14. Under certain worldwide taxation systems (notably, that of the United States), worldwide income is taxed and relief for double tax provided through the granting of a foreign tax credit. It is not clear how these rules could apply and would work in this case. The United States Council for International Business' (USCIB) response to this discussion draft provides detail in respect of this problem and, further, offers solutions. BIAC supports the solutions proposed by USCIB.

Ordinary income

15. The draft provides that a rule should apply in the case where a payment is deducted but not included in the "ordinary income" of the payee or in another jurisdiction.
16. However, an exact definition of the term ordinary income is not provided[1]. It is not clear whether capital gains income should be classified as "ordinary income". Paragraph 15 of the Discussion Draft notes that attributing ordinary income does not exclude it from benefiting from a tax exemption, but whether this would be the case would presumably depend on the relevant domestic legislation in respect of the mismatch rules and the nature of the tax exemption.
17. Further, given in most countries taxable profits are calculated from accounting profits, it is unclear how those tax deductions and income inclusions relating to accounting accruals (e.g. fair value movements) ought to be treated and whether they could create mismatch situations.
18. The timing of when amounts are subject to tax is not covered in the paper. The OECD should be clear that if an amount is to be subject to tax, even if it is not during the same period it would be brought into account in another jurisdiction which would subject it to tax under the branch mismatch rules, it should be treated as included in ordinary income and the hybrid mismatch rules should not apply. If governments are concerned about arrangements which intentionally defer an income inclusion for a significant time after the deduction is given, they should target this with a specific anti-avoidance rule which includes a motive test to ensure that there is no impractical general requirement to identify when all payments are recognised.
19. The treatment of foreign exchange differences and timing differences should also be clarified in the Discussion Draft. The Action 2 Final Report is clear that such differences should not be treated as hybrid mismatches and a corresponding clarification should be made in respect of forex under branch mismatch situations.

[1] We note that paragraph 32 of the Final Action 2 Report defines ordinary income and therefore it could be reasonably assumed that the same definition should be used in this report. The Final Action 2 Report definition requires that a foreign tax credit is only brought into account if it is computed on an item-by-item basis, so an inclusion under a worldwide taxation system (e.g. the US system), could result in items that are subject to tax not being included as "ordinary income" (and accordingly the third country would deny the deduction). This problem applies to both hybrid mismatches and branch mismatches.

CFC rules

20. It is set out in section 2 (diverted branch payments) that a receipt which is fully attributed to the ultimate parent of the group under a controlled foreign company (CFC) regime and has been subject to tax at the full rate should be treated as having been included in ordinary income for the purposes of the branch mismatch rule.
21. A CFC charge could nevertheless cause double taxation in any of the branch mismatch situations identified, particularly imported branch mismatch structures. The final draft should ensure that in all cases income that has been subject to tax under CFC rules is treated as included in ordinary income, or that CFC rules provide credit for taxes that arise as a result of such provisions. For example, a "diverted branch payment" may not be picked up in the head office or branch country, but could still be picked up by the CFC rules in the jurisdiction of an ultimate holding company of the group when it looks at the income of the entire legal entity.
22. As noted above, there is a need for a defense against double taxation via an exclusion for income taxed under CFC rules. However, we do have some concerns about the difficulty of determining and proving whether income has been subject to a CFC charge.
23. The entity applying the CFC rules may be far away in the chain of ownership from the entity applying the branch mismatch rules in the corporate structure of a MNE. The finance and legal team advising an entity that may be subject to branch mismatch rules may also be different to the team applying CFC legislation, and so it will not always be clear whether income has been subject to a CFC charge or not.
24. Further, it is difficult to see how a CFC inclusion can be effectively audited. A parent company is unlikely to be willing to share its tax return and details of its CFC calculation with multiple tax authorities, and therefore the burden of proof will be difficult to obtain. Tax administrations will struggle to verify whether the income has been subject to taxation and in order to be able to effectively audit this, they would require knowledge of other countries' CFC legislation and how it has been applied (particularly where there are areas of uncertainty in the CFC law, perhaps where there is ongoing litigation in relation to the CFC rules). In order to avoid this, we suggest a certification process by the CFC, subject to further verification that could be demanded by the other jurisdiction.
25. We would recommend that the OECD acknowledge in the final branch mismatch report that: (i) establishing a CFC inclusion can be challenging due to the need for information from the shareholder entity that has undergone the inclusion, (ii) a company should be able to rely upon a certification from its shareholder for purposes of claiming an exception resulting from a CFC inclusion by that shareholder; and (iii) any further documentation requirements upon audit should be limited to the minimum amount necessary to confirm the accuracy of the shareholder's representation (e.g., production of an appropriate excerpt from the shareholder's tax return).

26. There is also a risk of double taxation if income is subjected to certain other types of taxes, such as the UK's extra-territorial Diverted Profits Tax. BIAC would prefer if the recommendation could be drafted broadly enough to guard against double taxation in these circumstances.

Complexity of administration and compliance

27. Chapter 9 of the Final Action 2 Report set out a number of design principles in respect of the Action 2 recommendations, including requirements:

    (i) to be workable for taxpayers and to keep compliance costs to a minimum; and

    (ii) to be easy for tax authorities to administer.

    We are not certain that the proposals currently meet either of these aims.

28. There is some unavoidable complexity inherent in cross-border rules, because determining their applicability requires an understanding of a tax position in two countries (or, under the proposed rules, in some cases, multiple countries).

29. The tax treatment of a payment/receipt in a country, and consequently the results under the proposed branch mismatch rules, will therefore be complicated and in many cases will create uncertainty for taxpayers.

30. Moreover, under the proposed rules, in the case of one type of transaction, Imported Branch Mismatches, a country would deny a deduction for a payment because it considers, on the evidence available to it, that other countries do not apply the proposed rules to an associated branch mismatch transaction. This gives rise to particular complexity and difficult issues regarding the allocation of taxing rights across jurisdictions. For example, an MNE may provide funding through various intercompany sources which may include cash pooling arrangements, where excess liquidity is swept into a common pool under a loan arrangement and then passed to another part of the business. The treatment of corresponding interest deductions will depend on the location of the pooling vehicle (and whether it itself is subject to the imported mismatch rules). In order to ensure compliance, each company making a payment to a pooling entity would have to trace whether the receipt is used to on-pay interest, in case it is passed to a PE where a mismatch is created. A further complexity would arise if the head office jurisdiction's income is subjected to a CFC charge by another entity (which is covered in more detail below).

31. Both taxpayers and tax administrators would need to understand fully the tax treatment in two other countries (or more, if CFC rules must be considered) in respect of each potential mismatch transaction.

32. The corresponding burden on tax officials in administering these proposed rules and on taxpayers in complying with the rules should not be underestimated.

33. The rebuttal was made during the work on hybrid mismatches that taxpayers can avoid this problem by not entering into mismatch arrangements. However, branch structures are very often simply part of the way different jurisdictions interact for tax purposes. Finance and tax teams (like tax authorities) have a significant compliance burden which requires considerable local expertise. Accordingly, where mismatches have not been deliberately structured into,

these local specialists may not be aware of the tax rules in the counterparty jurisdiction for every transaction, and accordingly determining every mismatch of the types identified in this report will be challenging. Tax authorities and tax departments (even in large MNEs), may simply lack the resource to manage the volume of new compliance and audit obligations being generated. As noted above, an Action 2 design principle is to "keep compliance costs to a minimum", and we have set out below a suggestion that may assist in meeting this objective.

34. The BEPS work on Action 7 and lowering of the PE threshold means there are likely to be a greater number of PEs going forward. Although in reality we expect many of these to be "trading" branches, to which these rules may not be particularly relevant[2], it could still lead to an additional administrative requirement for businesses that need to undertake work to confirm that there are no mismatches.

35. We strongly encourage the OECD to provide that substantive trading permanent establishment operations be excluded from counteraction under the branch mismatch rules, in order to ensure that taxpayers do not have to spend significant resources completing assessments of their transactions to ensure that none of them are technically creating a mismatch. In such a case, all that is in practice happening is that the two jurisdictions have slightly differing approaches to the precise attribution of income and expenditure to the PE, but nonetheless arrive at substantially the same overall taxable profit attributable to the PE.

36. The OECD should also encourage jurisdictions to undertake comprehensive consultations before branch mismatch rules are incorporated into domestic law to identify particular issues that may arise (for example, interaction with the different ways that branch exemption regimes work in practice).

Interaction between domestic and international law

37. We are concerned that the Discussion Draft does not include a thorough analysis of the interaction between the domestic law change recommendations and treaties.

38. For example, a country may have existing treaty obligations that would limit the effectiveness of domestic law changes calling for limitations on a branch exemption (e.g., Article 23), or limitations on a branch's deduction of notional payments to a head office (Article 7), or denial of a deduction on payment to a separate entity (Article 24).

39. Any such domestic law recommendations should be accompanied by recommendations for making the appropriate treaty changes that would allow the desired solution to be effective. In no event should countries be encouraged to attempt to override their treaty obligations through domestic law changes.

40. Moreover, the recommended solutions under the Discussion Draft should be coordinated with solutions proposed elsewhere (e.g., the proposed exempt PE rule in the Action 6 Final Report) so

[2] We note that until the OECD's work on allocation of profits and losses to PEs is complete it is not possible to say this with certainty.

that countries are not led to trigger multiple countermeasures to the same problem. Again, that would dramatically increase the risk of double (or greater) taxation.

41. It should also be noted that the implementation of the Final BEPS Action 7 recommendations, will result in a significant increase in the number of PEs (and where this is implemented through the multilateral instrument ("MLI") these cases are imminent and extensive).

42. In negotiating a bilateral treaty, considerable time is spent by both countries in discussing examples and attempting to reach agreement on the exact definition of and requirements for of a PE to exist in the context of the specific treaty being negotiated. Where treaties are changed through the MLI, it is not expected that the same degree of discussion will take place, and BIAC is therefore concerned that, for each bilateral treaty amendment, there could be differences in interpretation of the applicability of the previous understanding to the new standard[3]. BIAC has set out in concerns in respect of the multilateral instrument in more detail in our letter of 30 June 2016, and in respect of the change to the PE rules in our letters of 9 January 2014, 12 June 2015 and 5 September 2016.

Other

43. Although the rules naturally need some in-built flexibility to allow countries to retain discretion over their own policies, there must also be limits on the scope of the rules, such that they do not unduly impinge on other countries' policies.

44. The proposals are, in effect, anti-avoidance rules, but the avoidance they are concerned with is of a type that depends on the interaction of at least two states' laws. While the mismatch may be an unintended consequence of the interaction of different jurisdictions' tax rules, in other cases it may be the result of an intentional policy decision on the part of one or more of the jurisdictions, such as an investment incentive or specifically targeted deduction. The proposed recommendations run a risk of undermining domestic policies that may be based on fiscal, economic and political considerations[4].

45. In our view the rules should be narrowed in scope to avoid this. For instance, they could be drafted to only apply when the parties enter into structured transactions to achieve a tax avoidance objective. Additionally, the definition of what constitutes "ordinary income" should be defined broadly in the final branch mismatch report, to ensure situations such as the one covered in footnote 4 do not create branch mismatch situations.

[3] For example, where a head office country does not recognise a PE and therefore does not exempt profits from taxation, yet the branch jurisdiction recognises and taxes the PE, this will frustrate policy aims where the head office seeks to exempt certain types of income.

[4] For example, under a targeted R&D regime, a country may choose to try to stimulate a certain type of economic activity by treating certain profits as "R&D income" or similar subject to tax at a reduced rate. The OECD has separate rules under BEPS Action 5 to ensure that such preferential regimes do not lead to harmful base erosion. Therefore, as long as the regime is compliant with the OECD standard, it seems counterintuitive that if the rules in question are applied to branch profits, they could be undermined through another territory's branch mismatch rules. We note that we would not expect patent box or similar income to be excluded from ordinary income just because it is subject to tax at a reduced rate, but this remains unclear without clarity in the definition of ordinary income.

46. The position in respect of claiming withholding tax credits should also be confirmed. We presume that the credit would be claimed in the jurisdiction where the income is ultimately subject to tax (i.e. inclusion income). If withholding tax is levied on a payment, jurisdictions should not be able to also deny a deduction for corporate income tax purposes.

47. The Discussion Draft is also silent on partnerships. Although they may be less likely to be structured into, it would be useful to have some guidance on this as in these cases it will be more difficult to ascertain the other party's tax treatment of a transaction.

<u>Questions for public consultation</u>

Section 2: Branch payee structures that give rise to D/NI outcomes

1. Are there any practical issues that could arise in denying the benefit of the branch exemption for a payment that is disregarded, exempt or excluded from taxation under the laws of the branch jurisdiction?

48. Yes. The rule attempts to neutralise mismatches in the allocation of income between the head office location and branch under the respective laws of these two jurisdictions. However, this should be determined with reference to the relevant tax treaty in place (if there is one) and subject only to domestic rules in areas the treaty does not cover.
49. For example, in the UK where branch mismatch rules are already being legislated, there were some unintentional, and harmful, consequences in the first draft, which was not widely consulted on. For example, where a UK branch election is made there was a risk that deductions which have corresponding taxable income may have been denied. A head office jurisdiction in the UK, under the draft rules, would tax either: (i) the worldwide profits of the entity, arising from external transactions; or (ii) only the head office jurisdiction profits, having exempted the branch (note that the exemption is irrevocable).
50. The branch mismatch rules in the UK, which were drafted in line with the Discussion Draft (albeit before its release), apply in all cases except where there is sufficient dual inclusion income. There is not any dual inclusion income where a UK branch exemption applies (for overseas permanent establishments of UK companies), nor where there is an overseas branch profits exemption (for UK permanent establishments of overseas companies). Where a UK company does not operate a branch exemption, there may, nonetheless, be a shortfall in dual inclusion income due to commercial circumstances in certain accounting periods.
51. In BIAC's view, it is not appropriate to create a tax charge under the mismatch legislation to counteract the proper deduction of the expense of a substantive, actively trading permanent establishment operation simply because it has low revenues.
52. The proposed approach thus seems to create undesirable adjustments where a branch computes its profits under the separate enterprise approach, which involves obtaining a range of tax deductions for amounts which are treated as payments to the head office jurisdiction, and those deductions cannot be directly traced to a share of a third party expense incurred by the enterprise. We believe that a range of such deductions are likely to arise in substantive commercial branch operations, and which are not abusive. Hence we believe the rule needs to better focus on any arrangements which are put in place with a tax related principal purpose, as set out above.
53. The way in which the proposed rules will interact with other domestic regimes has not been analysed comprehensively in the short period of time available to review the Discussion Draft, but we would expect other examples to arise.

2. Are there any practical differences between reverse hybrids, on the one hand, and disregarded branch and diverted branch payment structures, on the other, that would justify a different approach to that set out in Chapters 4 and 5 of the Action 2 Report?

54. BIAC’s view is that it is likely to be more challenging to determine whether the disregarded branch or diverted branch payment rules are triggered, given the relatively more ambiguous and fact-intensive standards for determining whether a presence rises to the level of a PE or branch and whether income is attributable to a branch, as compared with the question of whether an entity is a reverse hybrid.

3. Should the branch payee mismatch rule apply only to payments made under a structured arrangement or between members of the same control group?

55. BIAC recommends that these rules should be limited to apply only to payments made under a structured arrangement between members of the same control group (or within the same legal entity).
56. It is often not straightforward to ascertain the tax treatment of the other side of a transaction within a controlled group. This difficulty will be greatly increased in respect of transactions with unrelated parties.
57. We have explained above the rationale for focusing any counteraction on any arrangements which are put in place with a tax related principal purpose.

4. Are there any practical differences between hybrid entities and deemed branches and diverted branch payments that would justify modifying the scope of the rule or the guidance on the application of the structured arrangement rule to these types of branch mismatches?

58. One important difference is that the OECD has already published detailed standards for determining the existence of a notional separate entity in the form of a PE (i.e., Article 5) and for determining whether income is attributable to a PE versus the head office (i.e., the “Authorised OECD Approach” or “AOA”), whereas there is no comparable international standard or consensus around countries’ rules for characterizing entities or for considering income as attributable to one entity versus another.
59. That means that this Discussion Draft’s prescribed countermeasures to supposed branch mismatches, which are designed to ascribe taxing rights to a particular jurisdiction, may conflict with the results that could be achieved through consistent application of the existing standards already prescribed by the OECD.
60. If income is attributed under the AOA by the branch country, but by a non-AOA approach in the head office country (or vice versa), this could result in a hybrid branch mismatch. We believe that the simplest and most appropriate remedy is for all countries to commit to consistent adoption of the OECD’s guidelines on attributing profits to permanent establishments under the AOA, rather than implementing domestic rules that add an additional layer of complexity in an effort to undo the mismatch where it results in double non-taxation (but not where it results in double taxation).

5. Do the above paragraphs provide a clear explanation of the intended interaction between the branch payee mismatch rule and the ordinary rules for allocating income to a branch (including any rules consistent with those set out in Section 2.3 limiting the scope of the branch exemption)?

61. No. The paragraphs are confusing. For example, they call branch payee mismatch rule "the primary (and, in effect, only)" rule for neutralising disregarded branches and diverted branch payments, while at the same time appearing to recommend a limitation on the branch exemption as the primary means of solving those mismatches.
62. As we hope is clear from our foregoing comments, we do not believe that a counteraction under a rule for branch mismatches is appropriate where there are slight differences in the precise attribution of income and expenditure to the permanent establishment but both jurisdictions nonetheless arrive at substantially the same overall taxable profit for the permanent establishment. We also believe that recommendations which essentially require an assessment of two jurisdictions' views as to the nature and extent of every item of branch expenditure and income will be impractical and unworkable if applied to substantive commercial branch operations.

6. Should a payment to a branch be treated as included in income for the purposes of the disregarded branch or diverted branch payment rules if the payment is taken into account under the CFC rules in the parent jurisdiction?

63. If a payment is taken into account under the CFC rules in a parent jurisdiction it should treated as included in ordinary income. If it were not treated as ordinary income, there may be double taxation, which the OECD and BIAC agree is harmful to cross-border trade and not in line with the aims of the BEPS project. See our comments above in paragraphs 20 – 26.

7. Do the paragraphs above provide a clear explanation of when a disregarded branch and diverted branch payment will be treated as having given rise to a mismatch in tax outcomes?

64. No. As indicated above, the Discussion Draft does not clearly indicate what is meant by inclusion as "ordinary income". It does not go into the detail of the Final Action 2 Report regarding distinctions between mismatches due to timing and base differences versus mismatches due to differences in the geographic attribution of the income as between the branch and the head office.

8. What is the appropriate legal test for determining whether a payment made under a branch payee structure has given rise to a branch mismatch?

65. The branch mismatch rules should be triggered only in cases where there is a mismatch in treatment between related parties or under a tax structured arrangements.
66. Even in related party cases, we would propose that they are limited to cases where there is a tax avoidance motive to a transaction, in order to (i) avoid payment by payment analyses, (ii) prevent the unwarranted displacement of the normal process of the attribution of profits to

permanent establishments; and (iii) prevent the general over-riding of branch exemption regimes.

9. What other guidance (if any) is required to explain the intended scope of the branch payee mismatch rule.

67. The scope of these rules should be restricted in a pragmatic way per our detailed comments above.

Section 3: Deemed branch payments

10. Are there any practical differences between disregarded hybrid payments, on the one hand, and deemed branch payments on the other that would justify a different approach to that set out in Chapter 3 of the Action 2 Report?

68. No comments

11. Are there any practical issues that could arise in applying the branch mismatch rules to a deemed payment between the branch and head office?

69. Yes, see the practical issues as set out in our general comments.
70. It will be very difficult to identify deemed payments if the basis of calculation of income is not otherwise on the same basis (despite the definition provided that it should not include any deemed payment that is calculated with reference to a third party expense of the taxpayer). For example, in the case where the US is the residence country and taxes all of the income of the branch, this should be sufficient, despite the fact there is not a specific law or regulation including the deductible payment. Denying the deduction in this case will mean that the income is recorded in two jurisdictions and subject to double taxation.

12. Do you agree that a payment that is treated (for tax purposes) as made between the branch and head office but which, in practice, results in an allocation of third party expenses should be outside the scope of the deemed branch payment rule?

71. BIAC agrees that these payments should be outside the scope of these rules, but considers that this does not go far enough to prevent undesirable consequences, as set out above.

13. Do you agree that payments that represent or are calculated by reference to a third party expense should fall within the scope of the DD branch payment rules discussed in Section 4 below?

72. No comments.

14. Is it practical to distinguish between deemed and DD branch payments based on whether the notional payment is treated as an allocation of a third party expense by the taxpayer?

73. No comments.

15. Do you agree that no mismatch arises (and no adjustment should be required) under the deemed branch payment rule if the rules in the branch or residence jurisdiction operate in such a way as to ensure that the total amount of the taxpayer's income will be brought into account in at least one jurisdiction?

74. Yes.

16. Are there any practical difficulties in determining the amount of dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

75. Yes. See our detailed comments above.

17. Is further guidance required on the circumstances when the deemed branch payment rule should apply?

76. Yes, please see our general comments above.

18. Do you agree that the primary rule in respect of deemed branch payments should be to deny the deduction in the jurisdiction where the payment is deemed to be made?

77. No comments.

19. What further guidance (if any) is required on implementation solutions for the identification of dual inclusion income in the context of these branch mismatch arrangements?

78. No comments.

20. Do you agree that a secondary or defensive rule is required to address any mismatch in tax outcomes that could otherwise arise where the payer jurisdiction does not apply the primary rule?

79. No comments.

Section 4: DD branch payments

Section 4 (DD branch structures)

21. Do you agree that although these branch mismatch structures may not be thought of as "hybrid" they still fall within Recommendation 6 of the Action 2 Report and would be subject to adjustment under those rules?

80. Our earlier comments are equally applicable in the case of a rule addressing double deductions involving branches. How that rule is framed will be critical if it is not to have undesirable impacts. For all cases where the head office jurisdiction operates a worldwide basis of taxation, there will be a wide range of expenses arising in substantive commercial branch operation for which both the permanent establishment jurisdiction and the head office jurisdiction provide a tax deduction. The Discussion Draft proposes to identify the double deductions which are appropriate from a policy perspective by requiring there to be a deduction from dual inclusion income. However, depending upon how that is approached, a rule addressing double deductions will apply a counteraction where a branch is simply in a net loss position for a year (and hence there is insufficient dual inclusion income in the branch territory).
81. There will also be the problem outlined above of a mismatch arising when all that is in practice happening is that the two jurisdictions have slightly differing technical approaches to the precise attribution of income and expenses to the permanent establishment but nonetheless arrive at substantially the same overall taxable profit for the permanent establishment. For example, the permanent establishment jurisdiction may consider a branch expense to be deducted from an item of income, and the head office jurisdiction simply determines the income in a slightly different way – that might not strictly be dual inclusion income, even though there are no domestic policy concerns as both countries are taxing substantially the same overall taxable profit.
82. To prevent those problems, we believe a better approach is that any counteraction for double deduction cases only applies where the expense is actually set against income of another person, and that income is not dual inclusion income. For example, this might occur where a local entity is within a tax consolidation with the branch and some of that entity's income is actually offset by a branch expense, and the head office also deducts the expense against its head office taxable profits.

22. Are there any practical difficulties in determining the amount of duplicate deductions and dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

83. Yes. See detailed comments above.

23. Is further guidance required on the circumstances when Recommendation 6 should apply to DD branch payments?

84. No comments.

Section 5: Imported branch mismatches

24. Should the imported branch mismatch rules apply only to payments made under a structured arrangement or between members of the same control group?

85. The imported branch mismatch rules should be restricted to apply only to structured arrangements.
86. Even in the related party case, the complexities involved in MNE intragroup financing etc. will make the application of these rules extremely challenging and will create substantial complexity in administration and compliance, and the rule should only be applicable when the imported mismatch is part of the same wider arrangement – rather than requiring groups to undertake an assessment of whether a series of unrelated items in a multinational group could be argued to result in a branch mismatch being imported into a jurisdiction.
87. We agree that it would not be practicable to apply these rules to transactions involving members that are not in the same control group.

25. Are there any practical differences between branch and imported mismatches that would justify modifying or clarifying the scope of the rule or the guidance on the application of the imported mismatch rule?

88. The nature of the transactions that would be subject to the imported mismatch rules will make them more difficult to trace and hence compliance even more challenging.

International Co-operation and Tax Administration Division
OECD/CTPA

19 September 2016

Submitted by email: aggressivetaxplanning@oecd.org

CBI RESPONSE TO THE OECD PUBLIC DISCUSSION DRAFT ON BEPS ACTION 2 BRANCH MISMATCH STRUCTURES

As the UK's leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

The CBI has supported the OECD BEPS project since its inception and recognises the need to update international tax rules to address base eroding and profit shifting activity. The CBI welcomes the opportunity to provide comments on the OCED's Public Discussion Draft on BEPS Action 2 Branch Mismatch Structures ('Discussion Draft').

General comments

We understand the OECD's desire to produce further recommendations in relation to hybrid mismatches to deal with the possibility that arrangements addressed by the OECD's September 2015 Action 2 Report could be replicated through structures involving a branch or other permanent establishment. However, we believe that the proposals in the Discussion Draft need some changes in order to ensure that they are sufficiently focused on such policy concerns.

Many businesses carry out core business activities through significant operating branches, such as those in the banking, insurance, oil and gas sectors. We are concerned that the proposals as currently drafted in the Discussion Draft would disrupt the normal taxation of such operating branches when they are not actually involved in replicating the kind of arrangement addressed in the OECD's September 2015 Action 2 Report.

The commonly used separate enterprise approach to determining branch profits typically involves treating the branch as making a wide range of what the Discussion Draft refers to as deemed branch payments. Equally, where a company is subject to a worldwide basis of taxation in the head office jurisdiction there are likely to be a wide range of payments which are deductible in computing both the taxable profits in the branch jurisdiction and the worldwide taxable profits in the head office jurisdiction, and which are hence double deduction branch payments in the terms of the Discussion Draft. We have the following concerns in particular, which are relevant to both deemed branch payments and double deduction branch payments:

Attribution of profit

Many countries follow the OECD recommendations as to the attribution of profit to permanent establishments, such as the 2010 Authorised OECD Approach. Even so, there can be a range of differences in the precise items and amounts of income and expenditure which two territories might consider arise in a branch in a given period, whilst in both cases arriving at the position of identifying broadly the same taxable profit of the branch. In significant operating branches this is simply a consequence of applying the tax rules to the commercial activity undertaken, rather than as a result of trying to take advantage of a hybrid mismatch. Given those differences in the precise items and amounts of income and expenditure which two territories might consider arise in a branch in a given period, the approach of providing a safe harbour by reference to dual inclusion income is likely to be ineffective, and is also expected to impose a considerable (and potentially impractical) compliance burden involving the assessment of all items of income and expenditure in a significant operating branch. We therefore believe that the OECD's recommendations:

- need to be better focused on those arrangements which are actually seeking to replicate the arrangements addressed in the OECD's September 2015 Action 2 Report;
- should not involve a general revision of branch tax accounting; and
- should not involve the taxpayer in a general and wide-ranging consideration of its branch tax accounting in substantive operating branches.

<u>Branch losses</u>

The approach of providing a safe harbour by reference to dual inclusion income is also ineffective in cases where the branch incurs a net operating loss. In such cases the branch loss should be available for offset against head office profits and not restricted by any rule addressing hybrid mismatches. Similarly, where the relevant circumstances arise, a rule addressing hybrid mismatches should not restrict group relief for any loss in the head office jurisdiction.

If the desire is to provide a counteraction where a branch expense is actually offset against the income of another person and that other person's income is not taxed in the head office jurisdiction, that is a separate matter which does not need to involve the review of the branch's income (and hence the problems outlined above) to determine if a counteraction is applied.

<u>Inclusion of income corresponding to deemed branch payments</u>

Regardless of whether the head office jurisdiction applies a branch exemption or a worldwide basis of taxation, we would not expect income corresponding to a deemed branch payment to be included in the head office jurisdiction.

That is a natural consequence of the manner in which taxable profits are calculated in the head office jurisdiction. Therefore, whilst we agree that a deemed branch payment which is in effect an allocation of a third party expense should continue to be deductible, we believe that this does not go far enough. There are likely to be other valid expenses of an operating branch, arising under the separate enterprise approach, which it may not be possible to immediately link to a third party expense. For example, a bank may enter into a wide range of transactions with third parties in its head office jurisdiction, but it may not be possible to say that the specific transactions between branch and head office which the branch territory identifies under the separate enterprise approach correspond directly to the third party transactions of the bank. Nonetheless, the deductions arising in the branch territory are expected to be the appropriate tax deductible expenses of the branch following the Authorised OECD Approach, rather than resulting from a hybrid mismatch.

<u>Branch exemption regimes</u>

A branch exemption regime is a policy choice by the head office jurisdiction to exempt only the profits which it considers properly attributable to the branch. As a general matter it should not then matter whether the branch jurisdiction taxes those profits, applies a low rate of tax, exempts part of the branch profits, or allows a deduction that the head office territory would not if it were taxing the branch. For a normal operating branch none of this is a diversion of profit from the head office jurisdiction, and simply reflects the branch jurisdiction's view in relation to profits that the head office jurisdiction is prepared to exempt.

We therefore believe that the approach to arrangements such as that shown in Figure 3 of the discussion draft (where the branch gives tax relief for a deemed royalty payment to the head office) should not involve a recommendation that the branch exemption is overridden.

Solutions

We have had the opportunity to review the draft response to this consultation prepared by BIAC, and agree with the views expressed in that response and the proposals for solutions which could address the concerns we have outlined above.

We would be pleased to provide further input to the OECD in relation to developing solutions to the above concerns, but have not commented at length on these in this letter, in the interests of providing a response within the consultation timetable. For the same reason we have not addressed the individual consultation questions.

CONFEDERATION FISCALE EUROPEENNE

Opinion Statement FC 14/2016

on the OECD Discussion Draft

on Branch mismatch structures (BEPS Action 2)

Prepared by the CFE Fiscal Committee

Submitted to the OECD in September 2016

The CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 26 professional organisations from 21 European countries with more than 200,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe.
The CFE is registered in the EU Transparency Register (no. 3543183647-05).

We will be pleased to answer any questions you may have concerning CFE comments. For further information, please contact Piergiorgio Valente, Chairman of the CFE Fiscal Committee, or Rudolf Reibel, CFE Tax Policy Manager, at brusselsoffice@cfe-eutax.org.

Introduction

This Opinion Statement by the CFE Fiscal Committee relates to the OECD discussion draft "BEPS Action 2: Branch Mismatch Structures"[1] (hereinafter the "Discussion Draft"), released for public consultation on 22 August 2016 as a follow-up to the Action 2: 2015 Final Report (the "Report")[2].

Reference is made to the Opinion Statements submitted previously, i.e. (i) Opinion Statement FC 9/2014 of May 2014 and FC 4/2015 of February 2015 on Neutralising the Effects of Hybrid Mismatch Arrangements (BEPS Action 2)[3].

Our comments below will, to the extent relevant, repeat and further expand on, our comments and observations submitted earlier and will, *mutatis mutandis*, apply to all recommendations in the Discussion Draft, thus avoiding the need to respond specifically to the questions raised.

Please note that this is a preliminary Opinion Statement. A final version of this statement will be published in the forthcoming weeks on the CFE website: http://www.cfe-eutax.org/node/5545 .

1. EU Treaty Freedoms

As a general point, concern was raised regarding the compatibility of the solutions proposed by the OECD to counter BEPS with the EU Treaty freedoms. As the majority of OECD countries are EU member states, bound by the fundamental freedoms in the Treaty on the Functioning of the EU, notably the free movement of capital (Art.63 TFEU), and their interpretation by the EU Court of Justice, the success of any OECD solution to solve BEPS caused by hybrid mismatches will depend to a great extent on the compatibility of such a solution with the EU fundamental freedoms. One of the proposed rules that could result in a potential conflict with the EU Treaty freedoms is the branch payee mismatch rule where it does not concern a "wholly artificial arrangement". In light of the Cadbury Schweppes decision[4] of the Court of Justice of the European Union, a national tax measure aimed at countering tax avoidance which restricts an EU Treaty freedom (freedom of establishment in Cadbury case) may only be justified if it specifically relates to wholly artificial arrangements. Where a payment does not get taxed in the branch jurisdiction or in the jurisdiction where the head office of the branch is located as a result of a hybrid mismatch covered by the Discussion Draft, it would be difficult to successfully apply the branch payee mismatch rule where the arrangement/structure is not a wholly artificial arrangement that does not reflect economic reality.

2. Complexity of proposed rules in view of the tax treatment in one jurisdiction being contingent on the tax treatment in one or more other jurisdictions

2.1. The proposed recommendations to the types of mismatches identified in the Discussion Draft (i.e. (a) deduction/no inclusion outcome, (b) double deduction outcomes, and (c) indirect deduction/no inclusion outcomes) have in common that depending on the tax treatment in

[1] www.oecd.org/tax/beps/Discussion-draft-Action-2-Branch-mismatch-structures.pdf
[2] **Error! Hyperlink reference not valid.**
[3] Both Opinion Statements: www.cfe-eutax.org/node/3676
[4] Judgment of 12 September 2006 in case C-196/04: http://curia.europa.eu/juris/document/document.jsf?docid=63874&doclang=EN

one jurisdiction, income is included as taxable income in other jurisdiction or no deduction is allowed in the payee jurisdiction. The correct implementation of these recommendations will require initially the taxpayer and subsequently the tax authorities to confirm the tax treatment of certain payments. Therefore, these recommendations will be extremely difficult to implement in such a way to make it reasonably effective in practice.

2.2. By way of illustration of the comment made in par. 2.1 above, the proposed branch payee mismatch rule (i.e. denial of interest deduction by the payer jurisdiction) may not be practical as, under that rule, the payer (C Co) will be required to gather information as to the treatment of the interest payment at various levels within the group of companies.

2.3. Further, if the branch payee mismatch rule were to be introduced and that rule were to only apply to payments made under a structured arrangement or between members of the same control group, additional definition and tests would be required, thus making the proposed rule extremely complex. The risk of varying interpretations by the countries involved could increase and, as a result, the objective of the rule may not be realized.

2.4. In addition, limiting the branch payee mismatch rule to "structured arrangements", would, for it to be effective, require that there is complete agreement between the jurisdictions as to the meaning and scope of this term. If there is no such agreement, attaining the objective to solve the issues addressed by the Discussion Draft would prove to be illusory.

3. Implementation under domestic law versus an amendment of tax treaties.

3.1. Hybrid mismatches addressed in Action 2 mainly result from differences in domestic laws of the relevant countries, whereas most branch mismatches seem to arise from the application and interpretation of tax treaties (Art. 7 and Art 23A OECD Model) in combination with the lack of implementation of the principles set forth in the tax treaties under domestic law. Accordingly, CFE recommends that the issue of branch mismatches to the extent possible should be addressed in tax treaties by way of clarifications or modifications rather than the introduction of isolated rules in domestic laws. Thus, ideally domestic laws may need to be amended to support the functioning of the modified treaty provisions.

3.2. There is an additional reason for the CFE's recommendation to address, as a first step, branch mismatch structures through tax treaties. The disregarded branch structures and the diverted branch payments are essentially an issue of the different allocation by the jurisdictions involved of the assets and liabilities and income and expenses to permanent establishments. The recommended rules in paras 14-16 of the Discussion Draft, requiring modifications to domestic laws (i.e. exemption rules), should be such that they can operate effectively in practice. This will require existing tax treaties to be modified, first by clarifying the allocation (to permanent establishments) rules and the rules on the method for elimination of double taxation.

3.3. Explanation: As regards the disregarded branch structures, in many cases a tax treaty will be in place between the residence jurisdiction and the branch jurisdiction. The exemption method set forth in Art. 23A of the OECD Model Tax Convention provides for an exemption to be applied by the residence jurisdiction for the profit attributable to a permanent establishment (Art. 5 OECD Model). The profit attributable to the permanent establishment is determined on the basis of Article 7 of the relevant treaty. In view of the approach followed in Art. 7 and Art. 23A, the recommendation likely will have no effect in many cases, i.e. it may contravene the said treaty rules. CFE recommends to amend the tax treaties, i.e. to grant exemption to the extent the profits generated by the branch are actually taxed in the branch jurisdiction or, alternatively, to include a provision similar to Art. 23B OECD (Credit Method) as the main rule for avoidance of double taxation.

3.4. As described above, in par. 2.3., the *ultimum remedium* of the branch payee mismatch rule gives rise to complications that, by all means and where possible, should be avoided. From this perspective, the best way to avoid (the need for) application of the branch payee mismatch rule is to address the branch mismatch structures at the level of the branch and home jurisdiction in the form of the implementation of the relevant proposed rules in tax treaties supplemented by the adoption of amendment of domestic law rules that are consistent with the treaty rules.

Chartered Institute of Taxation

Excellence in Taxation

Ref: IT

21 September 2016

International Co-operation and Tax Administration Division,
OECD/CTPA

By e mail: aggressivetaxplanning@oecd.org

Dear Sirs

BEPS Action 2 Branch mismatch structures

We refer to the Discussion Draft published by the OECD on 22 August 2016 on *BEPS Action 2 Branch mismatch structures*.

The CIOT is an educational charity and one of our key aims is to work for a better, more efficient tax system for all affected by it. We strive for a tax system which provides greater simplicity and clarity, and also greater certainty for taxpayers. The CIOT responded to the OECD consultations on Action 2 in April/May 2014 and continues to recognise that actions in regard to hybrid instruments and hybrid entities form a central part of the BEPS programme.

The challenge in relation to branch mismatch structures is the complexity of the rules and the short timescale available to consider the potential unintended consequences in this difficult area. The recent experience in the UK demonstrates the difficulties in getting the rules right and a number of last minute amendments to the legislation were required as the legislation was passing through the Houses of Parliament to address the unintended consequences as these became apparent.

Many businesses use branch structures for commercial purposes, and, for example, where these structures are used for substantial enterprises in low tax jurisdictions, this should not be penalised as a result of this fact alone. It is also important to ensure that the rules will not apply in normal commercial situations, have unintended consequences for branches where there is no mismatch involved nor apply to normal commercial payments that have no tax avoidance purpose.

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CFE UK REPRESENTATIVE BODY ON THE CONFEDERATION FISCALE EUROPEENNE

Yours faithfully

Joy Svasti-Salee
Chair, International Tax Committee

The Chartered Institute of Taxation

The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 17,600 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

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Submitted by email: aggressivetaxplanning@oecd.org

Datum 19 September 2016
Referentie BR2553

Betreft: BEPS Action 2 – Public Discussion Draft on Branch Mismatch Structures

Dear madam, sir,

The Dutch Banking Association ("NVB") [1] welcomes the invitation from the OECD to comment on the Discussion Draft on Branch Mismatch Structures as published on 22 August 2016. We are happy to provide our comments on the Discussion Draft and trust our input will help to get an even better understanding of the specific situation of banks.

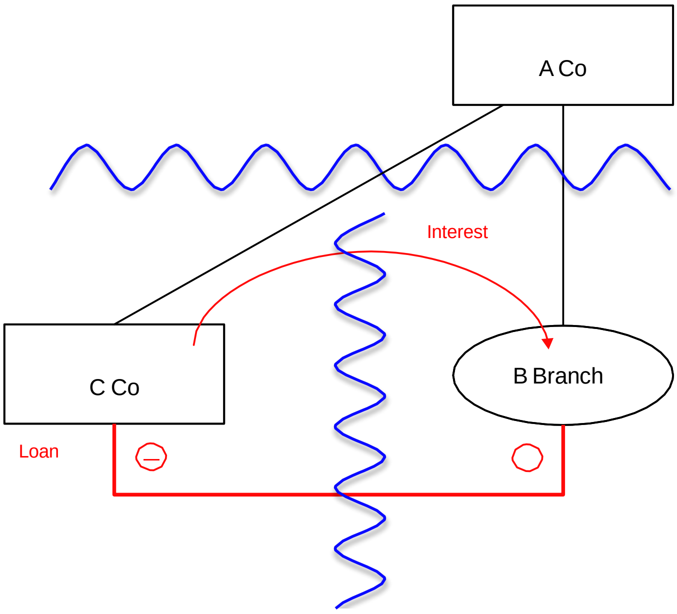
Bank branches are set up for commercial and regulatory reasons
The discussion draft seems to assume that branch structures may be set up with the aim to take advantage of mismatches in tax laws of different jurisdictions and tax treaty interpretations. However, bank branches are typically set up for commercial and regulatory reasons and any mismatch in the sense of the discussion draft would simply be the result of the (mandatory) application of relevant laws and treaties rather than a deliberate planning instrument. Therefore we would suggest that branches for which there is a clear commercial (and/or regulatory) rationale for existence and thus no structured arrangement is the case should be excluded from the recommended rules. Rather than complicating doing business with more and more complex rules the real way forward in our view would be for (OECD) countries to align their tax laws further.

Avoidance of double taxation
If, despite the above comments, countries were to consider implementing the recommended rules, we note the following. We have serious concerns about the scope of the rules as they focus almost entirely at situations where taxpayers may end up with a tax benefit and not so much with situations which result in double taxation. For all five types of mismatches discussed in the draft, for branches set up for commercial reasons the opposite situations are as likely to occur as the situations discussed in the example. If that happens double taxation would be the result. Therefore, the recommended rules (if any) should in our view be drafted in such way that also double taxation will be avoided.

[1] The Nederlandse Vereniging van Banken ("NVB") is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

To illustrate this we limit ourselves to two examples taken from the discussion draft, but similar comments can be made for all of them.

Example 1 *Disregarded Branch Structure*

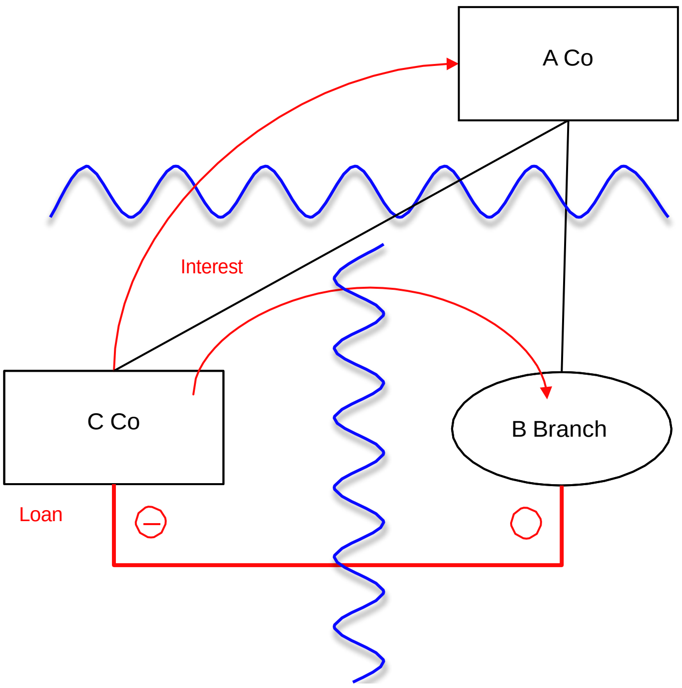


In this case A Co lends money to C Co (a related company) through a branch located in Country B. Country C permits C Co to claim a deduction for the interest payment. The interest income is taxed in Country A on the grounds that it is **not** attributable to a foreign branch because, according to the laws of Country A, A Co does not have a sufficient presence in Country B to be subject to tax in that jurisdiction (i.e. no permanent establishment has been created according to Country A). The interest income is, however, also taxed in Country B as, according to the laws of Country B, A Co has sufficient presence in Country B to be subject to tax there. The payment of interest therefore gives rise to an intra-group mismatch, but in this case resulting in double taxation.

Example 2 *Diverted Branch Payment*

This is almost the same example as the previous one, except that both the residence and branch jurisdictions recognise the existence of the branch. The mismatch arises due to the fact that the head office in Country A treats the interest payment as if it was paid directly to itself (so not including the income in branch income for which relief for double taxation is claimed), while the branch in Country B treats the payment as made to itself. As a consequence, the payment is subject to tax in both jurisdictions, a double taxation outcome.

Example 2 *Diverted Branch Payment*



Suggested actions
Branches with a clear commercial or regulatory rationale (such as bank branches) should be excluded from the scope of the rules in order to avoid complicating doing business further with highly complex tax rules.
If this is not possible, the recommended rules should be designed such that they not only prevent situations with less than single taxation but also situations in which there is double taxation.

We again thank you for the opportunity to provide our input and are obviously available for any questions you may have or assistance you need to explain the reasoning to to discuss any of the above comments in greater detail.

Yours sincerely,

Eelco Dubbeling
Managing Director

19 September 2016

International Co-operation and Tax Administration Division, OECD/CTPA
Organisation for Economic Co-operation and Development
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75775 Paris Cedex 16
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By email: aggressivetaxplanning@oecd.org

Comments on Public Discussion Draft on BEPS Action 2: Branch Mismatch Structures

Dear Sir, Madam,

EY appreciates the opportunity to submit these comments to the OECD on the public discussion draft on BEPS Action 2: *Branch Mismatch Structures* issued on 22 August 2016 (the discussion draft). The comments below relate solely to the scope and impact of the proposed recommendations included in the discussion draft and the question of whether such a broad scope was intended or warranted. Given the fundamental nature of the comments, we have not attempted to address the specific questions raised in the discussion draft. It will be important that further evaluation of the issues raised in the discussion draft takes account of the previous work done regarding attribution of profits to permanent establishments (PEs), the interaction with the existing tax treaty network, and the fundamental differences between branch mismatches and the hybrid mismatch situations discussed in the BEPS Action 2 report: *Neutralising the Effect of Hybrid Mismatch Arrangements* (the BEPS Action 2 report).

Core issues underlying mismatches involving branches

As a starting point, we would like to emphasize that the core issues underlying the branch mismatch structures as discussed in the discussion draft differ substantially from the core issues underlying the situations addressed in the BEPS Action 2 report.

The hybrid mismatch situations discussed in the BEPS Action 2 report relate to the use of hybrid instruments and entities, whereby the use of such hybrid entity or instrument is typically at the choice of the taxpayer. Such is not the case for branches. Whether certain activities constitute a PE is purely dependent on the threshold for recognizing taxable presence in a country where a foreign taxpayer's business activities are conducted.

We urge the OECD to be particularly mindful of industries in which the use of branches is prevalent due to regulatory or commercial reasons. Those situations should be evaluated and arrangements such as, for example, active trading branches, should be excluded from the scope of the proposed rules set forth in the discussion draft. Regulated financial services groups, particularly banking groups, have historically operated through branches for both regulatory and non-tax commercial reasons. The existence and substance of these operations are recognized both in the country where the branch is located and in the enterprise's home country. Applying an ordinary course of business exception would greatly reduce the possibility that the rules will unnecessarily impose significant administrative and compliance burdens.

Besides the fact that constituting a PE follows directly from the ordinary course of doing business in a country, taxpayers are also confronted with limited coherence in the rules amongst countries. The definition of what constitutes a PE varies from country to country as well as in the numerous bilateral tax treaties. Moreover, it is expected that variances in the determination of whether a PE exists will increase even more following the work under BEPS Action 7 and Action 15. Similar issues arise with respect to the frameworks used by countries to allocate profits to a PE.

Mismatches with respect to determining whether a PE exists, as well as with respect to the profits to be allocated to a PE, must therefore be considered the main rule rather than the exception to the rule. Such mismatches may result in double taxation of income as much as they may result in untaxed income. In this respect, it is noted that currently no consensus exists amongst BEPS Associates on the allocation of profits to a PE. For example, the Authorized OECD Approach (AOA) as described in the 2010 Report on the Attribution of Profits to Permanent Establishments (22 July 2010) is only adopted on a very limited scale, even amongst OECD countries. Other methodologies of allocating profits to a PE vary amongst countries. And even the AOA describes four different methods for allocating capital to a PE. There is a desire for more uniformity and therefore predictability in the definitions and methodologies. If such uniformity can be achieved, many if not all of the mismatches described would cease to exist. Therefore, we recommend the OECD put more effort in harmonizing PE definitions and stimulating adoption of the AOA, resolving the root cause of mismatches.

The effect of untaxed income would be mitigated or neutralized if a credit system is used as the method for the avoidance of double taxation in the country of residence. Save for a reference in paragraph 51 of the discussion draft however, there is no discussion of the differences between a credit and exemption system of taxation. For example, if the residence country taxes all of the income of the branch on the basis of worldwide taxation, and provides a credit for foreign taxes paid by the branch, the recommendations should not apply.

It is difficult to determine how the recommendations would work in connection with the myriad of existing tax treaty obligations. Those fundamental issues should be addressed and taken into account in designing any proposed recommendation in this area.

In view of the above, we therefore strongly recommend that further work be undertaken with respect to the question in what situations branch mismatches should be considered as posing a relevant BEPS risk and what measures best address these specific situations in a targeted way.

Complexity of the proposals and the interaction with other work on BEPS

As outlined above, the core issue underlying the branch mismatch structures is the difference between the definitions of a PE and the framework for allocating profits to a PE used by different countries. Under the proposed rules described in the discussion draft, both taxpayers – also those involved in structures generally not perceived as BEPS – and tax administrations will need to have substantial in-depth knowledge of the tax treatment of numerous transactions involving branch mismatch situations in other countries in order to properly adhere to and administer the proposed rules. This holds true specifically for the application of the imported branch mismatch rule discussed in section 5 of the discussion draft, whereby a third country will have to take into account the tax treatment of a specific payment in two countries. As a result, we expect that the application of the proposed rules will be extremely complex and difficult to apply for both taxpayers and tax administrations, thereby also adding to the administrative burden of both parties.

Furthermore, the work on BEPS Action 7: *Preventing the Artificial Avoidance of PE Status* causing lowered PE thresholds as well as the work on Action 6: *Prevent Treaty Abuse* and the proposed anti-abuse provisions therein, may substantially increase the number of PEs in the future.[1] We would expect this to put additional administrative burdens and pressure on taxpayers as well as tax administrations. The interaction with these recommendations has not been thoroughly addressed in the discussion draft.

<u>Fiscal sovereignty of countries</u>

Although the branch mismatch structures described in the discussion draft typically result from the interaction of different rules in two countries, we encourage the OECD to take into account the fiscal sovereignty of countries and the fact that certain mismatches are therefore the direct result of intentional tax policies of a country that may be at the core of its domestic tax system (for example, worldwide v. territorial system), or, are aimed to provide targeted investment incentives.

Paragraph 16 of the discussion draft, for example, recommends limiting the scope of the branch exemption where income is not taken into account for tax purposes by the PE in order to ensure that the branch exemption operates in line with the intended tax policy settings in the residence jurisdiction in respect of the taxation of worldwide income. This may however come in direct conflict with the policies of the resident country if the domestic tax system of that country is based on a territorial system. It seems that the OECD thus provides a policy overriding recommendation in the current public discussion draft: in case of untaxed income, domestic tax policies should be set aside in order to tax such income.

On the other hand, there may be circumstances where a source country may decide not to tax certain activities for domestic tax policy reasons. Consistent with the comments above, further evaluation of the recommendations in the discussion draft should be undertaken, taking into account tax policies of sovereign countries and any perceived abuse in this area.

<u>Process recommendation</u>

As outlined earlier, the issues underlying the branch mismatch structures result from the incoherence between the rules used by countries, both in domestic law and in tax treaties, to determine a taxable presence and the allocation of profits. These issues are at the core of (international) taxation and are – considering the interaction of (at least) two sets of domestic laws and tax treaties – extremely complex to apply. The proposed rules will only add to this complexity.

We therefore caution against proposing a set of complex rules without first evaluating: i) the nature and scope of the rules taking into account the work done regarding attribution of profits to PEs, ii) the interaction with the existing tax treaty network, and iii) the fundamental differences between branch mismatches and the hybrid mismatch situations discussed in the BEPS Action 2 report. Moreover, the

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[1] This may specifically hold true where the recommendations would be implemented via the multilateral instrument proposed in BEPS Action 15: *A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS*.

current recommendations could have an immense impact on ordinary course of business activities conducted via branches, most likely resulting in double taxation. These issues should be fully addressed and evaluated in future discussion drafts, reserving sufficient time for a comprehensive public consultation in order to identify particular issues that may arise as a result of any rules proposed in the future.

****

If you have questions or would like further information on any of the points discussed above, please contact Gerrit Groen (gerrit.groen@ey.com), Arlene Fitzpatrick (arlene.fitzpatrick@ey.com), Ronald van den Brekel (ronald.van.den.brekel@nl.ey.com), Jose Bustos (joseantonio.bustos@ey.com), or me, Alex Postma (alex.postma@jp.ey.com).

Yours sincerely
On Behalf of EY,

Alex Postma

MY ANSWERS TO THE QUESTIONS FOR PUBLIC CONSULTATION

2. Branch payee structures that give rise to D/NI outcomes

1. Are there any practical issues that could arise in denying the benefit of the branch exemption for a payment that is disregarded, exempt or excluded from taxation under the laws of the branch jurisdiction?

NO, UNLESS IF IT COULD DEPEND UPON THE NATURE OF THE PAYMENT.

2. Are there any practical differences between reverse hybrids, on the one hand, and disregarded branch and diverted branch payment structures, on the other, that would justify a different approach to that set out in Chapters 4 and 5 of the Action 2 Report?

I THINK THAT THERE AREN'T.

3. Should the branch payee mismatch rule apply only to payments made under a structured arrangement or between members of the same control group?

NO.

4. Are there any practical differences between hybrid entities and deemed branches and diverted branch payments that would justify modifying the scope of the rule or the guidance on the application of the structured arrangement rule to these types of branch mismatches?

NO.

5. Do the above paragraphs provide a clear explanation of the intended interaction between the branch payee mismatch rule and the ordinary rules for allocating income to a branch (including any rules consistent with those set out in Section 2.3 limiting the scope of the branch exemption)?

YES.

6. Should a payment to a branch be treated as included in income for the purposes of the disregarded branch or diverted branch payment rules if the payment is taken into account under the CFC rules in the parent jurisdiction?

IF THE TRANSACTION IS REAL AND "AT ARM'S LENGHT", IT COULD BE INCLUDED.

7. Do the paragraphs above provide a clear explanation of when a disregarded branch and diverted branch payment will be treated as having given rise to a mismatch in tax outcomes?

YES.

8 What is the appropriate legal test for determining whether a payment made under a branch payee structure has given rise to a branch mismatch?

WHEN THE PAYMENT ACCOUNTED AS A "COST" IN THE P/L OF THE BRANCH IS NOT COMPENSATED BY THE CORRESPONDING "REVENUE" IN THE P/L OF THE HEAD OFFICE.

9. What other guidance (if any) is required to explain the intended scope of the branch payee mismatch rule.

N/A.

3. Deemed branch payments

10. Are there any practical differences between disregarded hybrid payments, on the one hand, and deemed branch payments on the other that would justify a different approach to that set out in Chapter 3 of the Action 2 Report?

NO.

11. Are there any practical issues that could arise in applying the branch mismatch rules to a deemed payment between the branch and head office?

NO.

12. Do you agree that a payment that is treated (for tax purposes) as made between the branch and head office but which, in practice, results in an allocation of third party expenses should be outside the scope of the deemed branch payment rule?

FULLY AGREED.

13. Do you agree that payments that represent or are calculated by reference to a third party expense should fall within the scope of the DD branch payment rules discussed in Section 4 below?

YES.

14. Is it practical to distinguish between deemed and DD branch payments based on whether the notional payment is treated as an allocation of a third party expense by the taxpayer?

IT COULD BE.

15. Do you agree that no mismatch arises (and no adjustment should be required) under the deemed branch payment rule if the rules in the branch or residence jurisdiction operate in such a way as to ensure that the total amount of the taxpayer's income will be brought into account in at least one jurisdiction?

YES.

16 Are there any practical difficulties in determining the amount of dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

NO.

17. Is further guidance required on the circumstances when the deemed branch payment rule should apply?

NO.

18 Do you agree that the primary rule in respect of deemed branch payments should be to deny the deduction in the jurisdiction where the payment is deemed to be made?

YES.

19. What further guidance (if any) is required on implementation solutions for the identification of dual inclusion income in the context of these branch mismatch arrangements?

N/A.

20. Do you agree that a secondary or defensive rule is required to address any mismatch in tax outcomes that could otherwise arise where the payer jurisdiction does not apply the primary rule?

YES.

4. DD branch payments

21. Do you agree that although these branch mismatch structures may not be thought of as "hybrid" they still fall within Recommendation 6 of the Action 2 Report and would be subject to adjustment under those rules?

YES.

22. Are there any practical difficulties in determining the amount of duplicate deductions and dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

NO.

23. Is further guidance required on the circumstances when Recommendation 6 should apply to DD branch payments?
NO.

5. Imported branch mismatches

24. Should the imported branch mismatch rules apply only to payments made under a structured arrangement or between members of the same control group?
YES.

25. Are there any practical differences between branch and imported mismatches that would justify modifying or clarifying the scope of the rule or the guidance on the application of the imported mismatch rule?
NO.

European Business Initiative on Taxation (EBIT)

www.ebit-businesstax.com

Comments on OECD Public Discussion Draft on BEPS Action 2: Branch Mismatch Structures

To the attention of:

International Co-operation and Tax Administration Division - OECD/CTPA

Submitted by email to: aggressivetaxplanning@oecd.org

Brussels, 19 September 2016

Dear Sir / Madam,

EBIT is grateful for this opportunity to comment on the OECD's Discussion Draft on BEPS Action 2: Branch Mismatch Structures (the "Discussion Draft") dated 22 August 2016.

EBIT notes what is stated in the Discussion Draft about similarities with mismatches identified in the case of hybrid entities and hybrid instruments in the Action 2 Report of 5 October 2015 ("Neutralising the Effects of Hybrid Mismatch Arrangements"). However, we consider the potential recommendations set out in the Discussion Draft may catch arrangements that are commercially driven and have nothing to do with base erosion and profit shifting (BEPS). Given the existing complexities around branch taxation and profit attribution there is a clear risk that the recommendations give rise to an increase in double taxation than to curb any instances of double non-taxation in some territories. The proposal for primary and secondary rules applying to four different arrangements, with an additional imported mismatch rule creates material uncertainty and additional administrative burden for MNEs and tax administrations. Therefore, we would welcome the opportunity for territories to opt out of these branch proposals.

Tax policy perspective

From a tax policy perspective, if a territory chooses to adopt a territorial or quasi-territorial tax system and includes an exemption from tax for branch income arising in another territory, effectively including a 'subject to tax' condition as the Discussion Draft sets out seems to run counter to this policy choice.. Where there is a genuine concern about specific abuse, a CFC rule or more targeted provision might be more appropriate, depending on the circumstances. Any policy objective to address BEPS concerns arising from branch mismatches should also be targeted at specific structures, so that any proposed rules only apply to "payments made under structured arrangements or between members of the same group" and the mismatch rules should not apply to third party transactions.

EBIT can envisage situations in which under recommendations in the Discussion Draft an organisation operating via a branch (very often for non-tax reasons) would be taxed more onerously than an equivalent operation carried out in the same territory through a subsidiary. That could lead to market distortions which would be economically inefficient.

Commercial trading in low tax environments

It is EBIT's experience that the manner of operating commercially in some territories is largely prescribed by the regulatory regime in the country. For example, in the UAE, which might be recognised as a no or low tax environment, it is often preferable to operate through a branch for commercial and regulatory reasons. To dis-apply an exemption or partial exemption in the head office territory for branch income (a territorial or quasi-territorial regime) could be to tax in that territory activities which have no commercial connection with the head office. This would often impose increased taxation on normal trading transactions where there had been no profit shifting or base erosion, and would represent a significant "overreach" of the BEPS project.

Territories include a wide range of tax incentives specific to their local resources and investment needs. It would not necessarily appear appropriate to subject income which has benefited from such a 'tax holiday' or incentive in a branch location to tax under an entirely different set of criteria in the head office territory.

Interaction with PE attribution rules

EBIT is concerned about the wide range of differences in the method of profit attribution between the head office territory and branch territory, and the effects of the proposed changes to guidance on attribution of profit to PEs which were the subject of an OECD Discussion Draft issued on 4 July. Care will need to be taken to ensure that mere mechanical differences in the approach to profit attribution should not give rise to 'mismatches' within the ambit of any recommendations which may be taken forward.

The Discussion Draft states that one of the intentions is to avoid the risk of double taxation or disturbing any other tax outcomes, but it is not at all clear how the proposed changes to domestic law would interact with the double taxation conventions that individual countries have entered into, or the treatment of withholding taxes or credit for taxes paid that would arise where countries impose additional tax liabilities or deny deductions under the proposals.

Greater clarity would also be welcome on the definitions of "ordinary income" used in some of the draft, and definition of "mismatch", in particular, differences in timing of deduction and income recognition between different accounting policies in different jurisdictions should not be treated as a mismatch, and the treatment of foreign exchange differences should be clarified.

Further guidance is also required on the evidence required to demonstrate that a mismatch has not occurred and that the income has been subject to tax, including the way in which CFC taxation in another jurisdiction should be accepted as effective taxation of the income. It is surprising that the draft only refers to CFC inclusion in relation to the branch payee mismatch rule and not in any other proposed rules.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this important area. EBIT is committed to a constructive dialogue with the OECD and is always happy to discuss.

Yours sincerely,

European Business Initiative on Taxation – September 2016

For further information on EBIT, please contact EBIT's Secretariat via Bob van der Made, Telephone: + 31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com).

Mexico City, September 19, 2016

Via email

aggressivetaxplanning@oecd.org

International Co-operation and
Tax Administration Division
OECD/CTPA

On behalf of IFA Grupo Mexicano, A.C. (Mexican branch of the International Fiscal Association), below you will find our comments and input on the "Questions for Consultation" of the Public Discussion Draft on Branch Mismatch Structures.

I. Background

1. Foreign resident taxation in Mexico (branches)

Pursuant to the Mexican Income Tax Law ("MITL") a foreign resident is taxed in Mexico whenever such resident: (i) has as a permanent establishment ("PE") in Mexico for the income attributable to such PE, or (ii) it obtains Mexican source income, when it does not have a PE in the Country or when having so, income obtained is not attributable to such PE.

A PE is created for the performance of business activities and the provision of services in Mexico. The term PE usually comprises branches, agencies, offices, facilities among others. A PE is subject to income tax in Mexico at a rate of 30% on its tax profit for each tax year, determined as the sum of all its attributable income less authorized deductions, net operating losses ("NOLs") and profit sharing. PEs profit distributions to its home office are subject to an additional 10% income tax.

A PE in Mexico may consider as deductible items, expenses (including pro-rata expenses incurred by the home office), cost of goods sold, investments, interest, among other concepts that correspond to the activities of the PE either the ones disbursed in Mexico or elsewhere, provided that the requirements for authorized deductions established by the MITL and its Regulations are satisfied.

2. Mexican resident acting as home office of a branch located abroad

Mexican resident entities are subject to tax in Mexico at the 30% rate on tax profits earned each tax year, determined as the sum of their worldwide income less authorized deductions, NOLs and profit sharing. Worldwide income for a Mexican tax resident includes the gross income attributable to its branches that qualify as PEs located in a different jurisdiction. Mexican residents are entitled to consider the deductions for their own activities as well as deductions attributable to their branches (PEs) located abroad, provided that the requirements of the MITL and its Regulations for authorized deductions are satisfied.

The MITL does not provide for any branch tax exemption. All attributable income is taxed in Mexico.

3. Authorized deductions for a Mexican resident

Mexican resident entities are entitled to apply certain deductions against their taxable income. In 2014, the MITL incorporated certain additional deductibility rules.

The MITL provides that a Mexican resident entity (or a PE in Mexico of a foreign entity) is not entitled to deduct payments made when such payments are also deductible for a Mexican or foreign related party. This restriction would not apply (thus, the payment would be deductible) when the related party deducting the payment made by the Mexican taxpayer considers as taxable the income generated by such Mexican taxpayer in that tax year or in the following one.

In addition, the MITL provides that a payment would not be deductible when: (i) it qualifies as interest, royalty or technical assistance, (ii) payment is made to a foreign entity controlled by the Mexican taxpayer or that is controlled by the Mexican taxpayer; and (iii) a) the foreign recipient is transparent (unless and in the proportion its members or shareholders are subject to tax for that income and to the extent the payment is at arm´s length); or b) the payment is non-existent for tax purposes in the country or jurisdiction of the foreign entity, or c) the foreign entity does not treat the payment as taxable income pursuant to the applicable tax law. Payment includes the accrual of income or a portion of a payment.

II. Responses

1. Are there any practical issues that could arise in denying the benefit of the branch exemption for a payment that is disregarded, exempt or excluded from taxation under the laws of the branch jurisdiction?

Assuming Mexico is the branch jurisdiction, we note that the MITL does not provide for any branch tax exemption. All its attributable income is taxed in Mexico.

Assuming Mexico is the home office jurisdiction, we note that the MITL provides that a Mexican resident entity is taxed on its worldwide income including the gross income attributable to its foreign branches.

Based on the assumptions above, there are no practical issues under Mexican law applicable to disregarded payments, since income earned either by a branch (PE) or home office located in Mexico would be taxed herein.

2. Are there any practical differences between reverse hybrids, on the one hand, and disregarded branch and diverted branch payment structures, on the other, that would justify a different approach to that set out in Chapters 4 and 5 of the Action 2 Report?

We do not identify any practical differences among these concepts. Thus, the deduction for a Mexican resident entity making payments to reverse hybrids, disregarded branches or for payments that qualify as diverted branch payments, should likely be denied. We note that the MITL already includes provisions addressing these cases when payments qualify as interest, royalties or technical assistance as mentioned above.

3. Should the branch payee mismatch rule apply only to payments made under a structured arrangement or between members of the same control group?

We consider that the branch payee mismatch rule should apply only to payments made between members of the same control group. The current rule of the MITL applies only to entities of the same control group and based on the definition of control group. The rule addresses the control group approach and specific items (interest, royalties or technical assistance) instead of applying to a related party because under the MITL the concept of "related parties[1]" is broader that the "control group" concept.

With respect to the structured agreements, we anticipate practical difficulties in defining these agreements under Mexican legal provisions and evidencing the level of involvement, the understanding of the structure and its tax effects in a different jurisdiction, especially if these agreements are executed between unrelated parties. Unless the practical difficulties are overcome under the domestic legislation, the branch payee mismatch rule should not apply to structured agreements given their complexity and considering this rule would in any case apply to members of the same control group.

4. Are there any practical differences between hybrid entities and deemed branches and diverted branch payments that would justify modifying the scope of the rule or the guidance on the application of the structured arrangement rule to these types of branch mismatches?

The application of this rule to structured agreements is not recommended under Mexican domestic law. Please see response to question 3.

5. Do the above paragraphs provide a clear explanation of the intended interaction between the branch payee mismatch rule and the ordinary rules for allocating income to a branch (including any rules consistent with those set out in Section 2.3 limiting the scope of the branch exemption)?

The paragraphs should likely clarify cases when the full amount has been brought into account as ordinary income but no tax is finally paid due to NOLs, foreign tax credits ("FTC") or similar attributes. Also, the paragraphs should clarify whether the corporate tax rate (or effective tax rate) should be considered and, also, the timing for the inclusion of the ordinary income considering CFC and similar rules as stated in paragraph 24.

[1] The definition of related parties is linked to equity participation (regardless of the percentage), control or management.

6. Should a payment to a branch be treated as included in income for the purposes of the disregarded branch or diverted branch payment rules if the payment is taken into account under the CFC rules in the parent jurisdiction?

The payment to a branch should not be included as income for purposes of the disregarded branch or diverted branch payment rules if the payment is taken into account under the CFC rules in the parent jurisdiction, given the fact that the payment would be taxable in the parent jurisdiction without any tax deferral.

7. Do the paragraphs above provide a clear explanation of when a disregarded branch and diverted branch payment will be treated as having given rise to a mismatch in tax outcomes?

The paragraphs should address in detail the application (or non-application) of the rule to pension and retirement funds, governmental bodies, private equity or mutual funds, among others, considering the practical complexities of these entities.

8. What is the appropriate legal test for determining whether a payment made under a branch payee structure has given rise to a branch mismatch?

The test could consider if the rules are applicable, had the payment been made directly to the home office or ultimate parent, considering whether or not the home office or ultimate parent would include such income as ordinary income subject to tax in its jurisdiction.

9. What other guidance (if any) is required to explain the intended scope of the branch payee mismatch rule.

Whether or not the corporate tax or effective tax rates should be considered in applying these rules and tax attributes such as NOLs or FTC. Also, the rules should address their application to tax exempt or transparent entities or vehicles (funds, etc.) to provide certainty to their investments when using branches.

10. Are there any practical differences between disregarded hybrid payments, on the one hand, and deemed branch payments on the other that would justify a different approach to that set out in Chapter 3 of the Action 2 Report?

The report should probably clarify the value added tax ("VAT") (or any other applicable indirect tax) and withholding tax effects in a deemed branch payment addressing whether or not these taxes are triggered.

11. Are there any practical issues that could arise in applying the branch mismatch rules to a deemed payment between the branch and head office?

The MITL provides that PEs located in Mexico and their home office and other PEs abroad are related parties. Conversely, a Mexican resident entity acting as a home office should not consider its foreign PEs as related parties, given the fact that from a legal (and tax perspective) they are the same entity. Therefore, the MITL recognizes the deemed payments, due to the fact that any payment borne by a branch (PE) should be made pursuant to the transfer pricing rules, whether or not they are only cash flows to the home office (unless the payments qualify as profit distributions).

Accordingly, if a branch located in Mexico does not satisfy the arm's length principle, the considerations agreed in operations carried out by the branch and its home office –and any other branch– may be adjusted by the Mexican authorities. Likewise, the MITL provides that when a foreign authority adjusts the consideration set forth between related parties, the Mexican branch may adjust its Mexican tax returns, to the extent the Mexican authorities approve and agree with the transfer pricing adjustment and the home office is a resident of a country with which Mexico has entered into a Tax Treaty. It is worth mentioning that secondary adjustments *per se* are not allowed under the applicable Mexican tax provisions.

Based on the above, a branch located in Mexico should consider deductible the deemed payments (the MITL does not allow the deduction of payments of profits made by a branch to its home office, even if those profits payments are characterized as royalties, service fees, commission fees or interests), satisfying also the transfer pricing rules.

The foregoing may imply the following practical issues:

1. Adjustments. The MITL is not clear on how the adjustments performed by a foreign authority should be reflected in connection with the deemed payments, and its taxable income/deductions.
2. VAT. The VAT Law is not clear on how the deemed payments should be recognized for VAT purposes.[2]
3. Corporate Income Tax (CIT) withholding. The MITL is not clear on how the deemed payments should be recognized for CIT withholding effects.[3]

12. Do you agree that a payment that is treated (for tax purposes) as made between the branch and head office but which, in practice, results in an allocation of third party expenses should be outside the scope of the deemed branch payment rule?

Yes, we agree.

13. Do you agree that payments that represent or are calculated by reference to a third party expense should fall within the scope of the DD branch payment rules discussed in Section 4 below?

Yes, we agree.

14. Is it practical to distinguish between deemed and DD branch payments based on whether the notional payment is treated as an allocation of a third party expense by the taxpayer?

Yes, we consider it is practical.

15. Do you agree that no mismatch arises (and no adjustment should be required) under the deemed branch payment rule if the rules in the branch or residence jurisdiction operate in such a way as to ensure that the total amount of the taxpayer's income will be brought into account in at least one jurisdiction?

We agree. A mismatch should be deemed to occur when neither the branch nor the residence jurisdiction taxes the total income.

[2] The Commentaries to the OECD Model Tax Convention provide that the deemed payments should not have any tax effect, rather those for the transfer pricing rules. However, Mexico does not accept the additional commentaries stated after 2010 with respect to the deemed payments, and thus, the latter interpretation is not necessarily applicable.
[3] Op. Cit.

16. Are there any practical difficulties in determining the amount of dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

We do not see any practical difficulty, to the extent that it is considered all the income as if it derives from the residence jurisdiction and the credit/deductions rules are clear.

17. Is further guidance required on the circumstances when the deemed branch payment rule should apply?

No.

18. Do you agree that the primary rule in respect of deemed branch payments should be to deny the deduction in the jurisdiction where the payment is deemed to be made?

Yes, we agree. However, such rule should clarify that the deduction should not be denied to the extent income is taxable in any jurisdiction even though it is not the branch or home office jurisdiction (i.e. based on CFC rules).

19. What further guidance (if any) is required on implementation solutions for the identification of dual inclusion income in the context of these branch mismatch arrangements?

Further guidance may be needed with respect to the FTC or NOLs rules that may avoid the payment of tax even if the income was properly included.

20. Do you agree that a secondary or defensive rule is required to address any mismatch in tax outcomes that could otherwise arise where the payer jurisdiction does not apply the primary rule?

Yes, we agree.

21. Do you agree that although these branch mismatch structures may not be thought of as "hybrid" they still fall within Recommendation 6 of the Action 2 Report and would be subject to adjustment under those rules?

Yes, we agree given the fact that the mismatch effects are the same.

22. Are there any practical difficulties in determining the amount of duplicate deductions and dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

We do not anticipate at this point any practical difficulties.

23. Is further guidance required on the circumstances when Recommendation 6 should apply to DD branch payments?

No further guidance seems to be needed.

24. Should the imported branch mismatch rules apply only to payments made under a structured arrangement or between members of the same control group?

These rules should apply to payments made between members of the same control group. With respect to the structure agreements, see comments on question 3 above.

25. Are there any practical differences between branch and imported mismatches that would justify modifying or clarifying the scope of the rule or the guidance on the application of the imported mismatch rule?

We do not foresee any practical differences.

* * *

The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA branch and in no case in the name, or on behalf, of Central IFA or IFA as whole.

We hope you find these comments interesting and useful. We remain yours for any questions or comments you may have.

Sincerely,

IFA Grupo Mexicano, A.C.

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

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September 19, 2016

VIA E-MAIL

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Re: Comment on Discussion Draft on BEPS Action 2 (Branch Mismatch Structures)

Dear Sir or Madam,

This letter is submitted on behalf of the International Alliance for Principled Taxation (IAPT or Alliance) to provide you with the IAPT's comments on the August 22, 2016 Discussion Draft on BEPS Action 2 (Branch Mismatch Structures) (Discussion Draft). We appreciate the opportunity to provide input on the Discussion Draft to the OECD and its Working Party No. 11 on Aggressive Tax Planning (WP11).

The IAPT is a group of major multinational corporations based both within and outside the EU, and representing business sectors as diverse as consumer products, media, telecommunications, oilfield services, computer technology, energy, health care, beverages, software, IT systems, publishing, management consulting, and electronics.[1] The group's purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally. The group participated actively as a stakeholder in the discussions leading to the October 2015 final reports from the OECD/G20 BEPS Project.

[1] The current membership of the IAPT is made up of the following companies: Accenture plc; Adobe Systems, Inc.; Anheuser-Busch InBev NV/SA; Cisco Systems, Inc.; The Coca-Cola Company; Exxon Mobil Corporation; Hewlett Packard Enterprise Company; Johnson & Johnson; Microsoft Corporation; Procter & Gamble Co.; RELX Group plc; TE Connectivity Ltd.; Thomson Reuters Corporation; Transocean Ltd.; Tupperware Brands Corporation; Vodafone Group plc; and Yum! Brands, Inc.

As we indicated in comments we submitted to the OECD in May 2014, the IAPT fully supports the OECD initiative to develop clear and consensus recommendations on domestic laws to counter aggressive tax planning through the use of hybrid mismatch arrangements, and supports the extension of the scope of the Action 2 recommendations to branch mismatch structures. We understand that countries have concerns with scenarios involving branch mismatches, and we acknowledge the legitimacy of the OECD's effort to develop ways to counteract certain adverse consequences of these arrangements. However, the IAPT has material concerns in relation to some of the recommendations, in particular the proposal that countries adopt domestic rules limiting the scope of their branch exemption in very broad circumstances. Moreover, some of the recommendations in the Discussion Draft undercut, and in some cases conflict with, the important ongoing work of the OECD in the area of profit attribution to permanent establishments.

The group's comments are set forth in Annex I to this letter. As many of the comments are general in nature or address more than one of the consultation questions raised in the Discussion Draft, we have not provided our comments in the form of specific responses to each of the consultation questions. For ease of reference, however, we have provided cross-references between our comments and the consultation questions as Annex II to this letter.

We very much appreciate the willingness of the BEPS Project delegates to consider the IAPT's comments as they continue their deliberations on this matter.

Sincerely yours on behalf of the Alliance,

James A.D. Wilson
Baker & McKenzie LLP
Counsel to the Alliance

ANNEX I

IAPT Comments on the August 22, 2016 Discussion Draft on BEPS Action 2 (Branch Mismatch Structures)

I. Introduction

1. Set out below are IAPT's comments on the OECD Discussion Draft on BEPS Action 2 regarding branch mismatch structures published on August 22, 2016. The Alliance commends the OECD on its effort to recommend clear and comprehensive recommendations in this area, and is generally in agreement with the high-level principles put forward in the Discussion Draft.

2. Nonetheless, the Alliance has concerns with some of the recommendations in the Discussion Draft, which we discuss in more detail below. In the main, these concerns arise in areas where the Discussion Draft appears to be recommending unnecessary measures that interfere with countries' legitimate tax policy choices or overlap (and sometimes conflict) with existing OECD work. The Alliance is also concerned that the recommendations in the Discussion Draft overlook a number of material practical difficulties inherent in applying the proposed measures. Finally, the proposed measures also create arbitrary distinctions in tax outcomes between branches and subsidiaries.

II. Introductory comments on scope of the recommendations on branch mismatch structures

3. Before commenting on the individual structures and the issues posed by their recommended solutions, the IAPT would like to make an introductory comment about the scope of the recommendations on the first three structures covered in the Discussion Draft. The Alliance agrees that the disregarded branch structure outlined in Section 2.1 of the Discussion Draft is analogous to the hybrid mismatch arrangements targeted by the BEPS Action 2 Report in that the deduction/non-inclusion mismatch (D/NI mismatch) arises from different domestic law treatment of the branch as between the branch and head office jurisdictions (i.e., whether the branch is recognized as a notional separate entity or not). This is similar to the different domestic law treatment of hybrid instruments and entities targeted by the Action 2 Report, and it is therefore rational to consider counteraction of these mismatches in the same way.[2]

4. The diverted branch payment and deemed branch payment structures outlined in Sections 2.2 and 3 of the Discussion Draft, while similar in outcome, are less similar in cause to the D/NI structures targeted by the Action 2 Report. The D/NI mismatch in these cases arises not from a difference in the way in which the branch (or, in the context of the Action 2 Report, entity or instrument) is characterized for tax purposes, but rather in a difference in the way income is allocated as between head office and branch. This distinction is meaningful because the OECD has already promulgated detailed and extensive guidance on the attribution of profits to permanent establishments. Adoption of the authorized OECD approach to profit attribution (AOA) by all jurisdictions ought to address any double non-taxation concerns arising as a consequence of differing approaches to profit attribution, and the promulgation of

[2] See, however, our comments below regarding the disregarded branch structure recommendations.

recommendations for domestic law changes like those contained in the Discussion Draft may have the consequence of reducing the incentive to adopt the AOA.

5. To illustrate this, consider the example given at paragraph 28 of the Discussion Draft. In that example, a mismatch arises due to a difference in the way in which the branch and head office jurisdictions allocate intellectual property owned by the entity. The recommendation in the Discussion Draft is that this mismatch be countered in the first instance by denying a deduction for the deemed royalty payment and, in the event the branch jurisdiction does not introduce branch mismatch rules, for the deemed payment to be included in ordinary income in the head office jurisdiction. This recommendation, while superficially addressing the mismatch, does not require or incentivize either the branch or the head office jurisdiction to apply the AOA consistently. In fact, the recommendation may operate as a disincentive to apply the AOA, in that the branch mismatch rule may be perceived as having addressed the issue. By taking this approach, the branch mismatch rules effectively override the AOA. Indeed, the recommendation may incentivize branch jurisdictions to over-attribute income to a branch, contrary to the AOA principles, in order to avoid leaving any apparent mismatch that the head office jurisdiction might be inclined to remedy through asserting its own taxing rights.

6. In the paragraph 28 example, the secondary response to the mismatch is to require income inclusion in the head office jurisdiction, the effect of which is essentially to provide that ownership of the intellectual property is properly attributable to the head office. However, the recommendations do not require that this treatment be applied by the head office jurisdiction in general. This could result in the head office jurisdiction denying (for example) tax relief for amortization of the intellectual property on the basis that it is attributable to the foreign branch, while simultaneously taxing notional royalty income under the branch mismatch rule. This is just one example of the unintended consequences that could arise if new rules intended to allocate income in a particular way between a branch and head office are overlaid upon an existing set of rules intended to do the same thing, without any coordination between the two rules.

7. In paragraph 36 of the Discussion Draft, the OECD notes that deemed payments are treated as outside the scope of the Action 2 Report on the basis that the "*deduction attributable to these items does not relate to an actual expense of the taxpayer*" and that "*deemed interest deductions and other similar regimes (such as allowances for equity capital) are specific tax concession designed to lower the effective tax rate of the taxpayer in the payer jurisdiction by reducing the taxpayer's taxable base and are, therefore, functionally closer to a reduction in tax rate than a deduction for an actual expense.*" In the context of deemed branch payments, a distinction is made on the basis that they are a product only of "*differences between the rules used in branch and residence jurisdictions for calculating and apportioning income and expenditure between the branch and head office.*" In the view of the Alliance, this distinction is not clear. It is conceivable that a jurisdiction might choose to include an allowance for equity capital as a specific tax concession applicable to both subsidiaries and branches in the jurisdiction. In the branch context, this might operate as a notional deduction on the equity capital attributable to the branch, in the same way that a notional deduction would be applied to the equity of a subsidiary in calculating the subsidiary's taxable profits. The recommendations in the Discussion Draft would, if

implemented, result in a disallowance of the deemed deduction in the branch context but not in the context of a subsidiary - a difference in approach that has no obvious justification in principle.

8. Both of the concerns above illustrate the difficulty that arises in designing simple rules to combat branch mismatches that do not have unintended consequences. In the view of the IAPT, differences in approach to the allocation of income as between branch and head office are most appropriately dealt with through the OECD's work on the AOA rather than under Action 2.

III. Disregarded branch and diverted branch payment structures

9. As indicated above, the Alliance understands the similarity between the disregarded branch structure outlined in Section 2.1 of the Discussion Draft and the reverse hybrid structure addressed in the Action 2 Report. Thus, we understand the inclination to provide countermeasures against the structure. That being said, we see certain difficulties with the proposals. For the most part these same difficulties apply with respect to the recommendations for diverted branch payment structures.

A. Practical distinction between reverse hybrid and disregarded branch or diverted branch payment structures

10. We do see a practical distinction between reverse hybrid entities and disregarded branch or diverted branch payment structures. The question of whether non-inclusion in the branch jurisdiction is due to that jurisdiction's not viewing the branch as giving rise to a taxable presence or not viewing the income in question as attributable to or otherwise taxable to the branch may be a complicated factual question, the resolution of which would not be necessary other than for purposes of applying the branch mismatch rule. This represents a significant practical difference between the disregarded branch structure and the cited analogue from the Action 2 Report, the reverse hybrid structure, where the reason for the non-inclusion in the reverse hybrid jurisdiction is likely clear from a straightforward legal analysis.

B. Concerns regarding proposed limitation on branch exemption

11. We note that the Discussion Draft appears to recommend two solutions to the disregarded branch and diverted branch payment structures: first, that the head office jurisdiction force an inclusion by denying the branch exemption[3]; and second, that the payer jurisdiction deny a deduction for the payment to the disregarded branch or diverted branch payment structure.

12. By contrast, we note that the primary solution proposed for the reverse hybrid analogue in the Action 2 Report is the denied deduction in the payer jurisdiction. This difference may be due to the remarkably (and, we believe, excessively) broad nature of the Discussion Draft proposal, which does not even require the payment in question to be deductible in the payer jurisdiction for the proposed countermeasure in the form of the denied branch exemption to be triggered. In other words, the recommendation appears to be that the head office jurisdiction should deny the exemption even in the absence of a "deduction/non-inclusion" result. In our view, this is too broad, and no countermeasure

[3] In fact, the Discussion Draft is somewhat unclear as to whether its description of the limitation on the branch exemption is actually intended to be a recommendation. Given the ambiguity, we shall assume that it is so intended.

should be triggered in the disregarded branch or diverted branch payment case unless there has been a payment that is deductible in the payer jurisdiction.

13. Similarly, the Discussion Draft appears to suggest that the limitation on the branch exemption in the head office jurisdiction may apply whenever an income item is not actually taxed in the branch jurisdiction, regardless of the reason for that non-taxation. It recommends that the branch exemption be denied for any "payments that are disregarded, exempt or excluded from taxation under the laws of the branch jurisdiction". We believe this makes the recommendation much too broad, as it goes well beyond cases where there is a mismatch in branch characterization or income allocation between the head office and branch jurisdictions and affects any situation where income is not actually taxed in the branch jurisdiction. This causes the recommendation to operate in a way that interferes with the sovereign decisions of the branch jurisdiction about whether to exempt or exclude income. We believe the recommendation to limit the branch exemption should apply, if at all, only to cases where the non-taxation in the branch jurisdiction is due to that jurisdiction's disregarding the existence of the branch or due to diverted payment structures.

14. For example, many jurisdictions' tax regimes provide a full exemption from tax on dividends received by a resident, whereas others provide for partial exemption only. If a dividend payment was made to a substantive branch operation in a full exemption jurisdiction, OECD-compliant profit attribution and taxing-right allocation principles would dictate that the determination of whether or not to tax the dividend falls to the jurisdiction of the branch. This is entirely consistent with the "separate entity" theory and maintains parity between the treatment of branches and subsidiaries (a parity that in certain areas, for example European Union law, some jurisdictions are required to maintain). If the recommendation in the Discussion Draft were adopted, the branch jurisdiction's dividend exemption regime would effectively be ignored, and the head office jurisdiction, which may offer a partial (or no) exemption, would be applied in its place.

15. Moreover, we believe the Discussion Draft needs to be clarified to better articulate the interaction between the branch exemption limitation rule and the branch payee mismatch rule recommended at Section 2.3. We believe the intended effect is to have the branch exemption limitation rule operate as the primary solution to the disregarded branch (and diverted branch payment) structure, with the branch payee mismatch rule to apply only if there a deduction/non-inclusion result would otherwise prevail (i.e., if such a result had not already been precluded by the triggering of the branch exemption limitation rule). But the Discussion Draft is unclear on this point, as it states that the branch payee mismatch rule "is the primary (and, in effect, only) rule" for neutralizing these types of branch mismatches, and it says the branch payee mismatch rule should not apply "where, following a proper application of the rules for allocating income in the residence and branch jurisdictions, it is determined that, in aggregate, the full amount of the payment has been brought into account as ordinary income under the laws of at least one jurisdiction". This reference to "proper application" (and a similar reference to the "ordinary rules for allocating branch income") leaves it unclear whether the determination of the applicability of the branch payee mismatch rule is to be made *before or after* taking into account the potential applicability of the special branch exemption limitation rule that might be triggered by the mismatch. If the branch payee

mismatch (deduction denial) rule is not clearly positioned as a defensive measure to apply only in the absence of a branch exemption limitation rule, there will be a risk of double taxation.

16. A related point is that, in effect, the proposal to deny the branch exemption in the head office jurisdiction amounts to a blanket "CFC" rule for foreign branches, forcing an inclusion in the head office jurisdiction in any case where the branch jurisdiction, for whatever reason, does not include the income for tax purposes. This undercuts, in the branch context, the right of individual countries to design the scope of their CFC regimes in a more nuanced manner in a way that is not equally applied to subsidiaries in the OECD's Action 3 recommendations. We note, for example, that both the U.K. CFC regime[4] and the CFC regime to be implemented under the EU's Anti-Tax Avoidance Directive require CFC inclusions from branches, but only in certain circumstances. The Discussion Draft's forced inclusion in the head office jurisdiction whenever the branch jurisdiction does not tax the income item undermines the branch jurisdiction's policy choice on whether to tax the income as well as the head office jurisdiction's policy choice on whether to apply its CFC regime to the branch,

17. The Discussion Draft also recognizes another inherent defect in this proposal, which is that in some cases the residence jurisdiction may be prevented from limiting the scope of its branch exemption under the terms of a double tax treaty with the branch jurisdiction.

18. In summary, in the view of the Alliance this proposal to limit the branch exemption goes beyond what is necessary to neutralize mismatches in outcomes arising through branch structures, would be difficult to implement uniformly and could result in unintended adverse consequences for taxpayers. The proposal is also not justifiable as a response to BEPS concerns arising from branch mismatches, which concerns are addressed by the other recommendations in the Discussion Draft. We would therefore urge that the proposal be dropped.

C. Concerns regarding application of the branch payee mismatch rule

19. Paragraph 18 of the Discussion Draft recommends that the payer jurisdiction adopt a "branch payee mismatch rule", denying a deduction for the payment to the disregarded branch "if the branch structure gives rise to a mismatch in tax outcomes".

20. As indicated above, we believe the Discussion Draft needs to be clarified to better articulate the interaction between the branch exemption limitation rule and the branch payee mismatch rule recommended at Section 2.3.

21. Paragraphs 21 and 22 of the Discussion Draft make clear the intention that the branch payee mismatch rule will only apply where there is a mismatch under the ordinary rules for allocating branch income. As indicated above, we believe the language leaves it unclear whether the determination of the applicability of the branch payee mismatch rule is to be made *before or after* taking into account the

[4] The U.K. rules, contained in Chapter 3A Part 2 Corporation Tax Act 2009, essentially treat a branch of a U.K. resident company as a separate legal entity and then apply the U.K. CFC rules to that notional separate entity. In this way, the rules respect the principle of equivalence of branches and subsidiaries.

potential applicability of the special branch exemption limitation rule that might be triggered by the mismatch, and that point needs clarification.

22. We infer from the language that the branch payee mismatch rule is not intended to apply where a D/NI mismatch arises as a consequence of the branch or head office being located in a jurisdiction that does not impose tax. This would be consistent with the scope of the recommendations in the Action 2 Report, which explicitly excludes mismatches arising from differences in tax rates. However, by referring to payments being "*brought into account as ordinary income*" the Discussion Draft is not explicitly clear on this point, because it is not clear how the concept of "ordinary income" is intended to apply in the context of income accruing to an entity in a jurisdiction that does not impose tax. In the view of the Alliance, it would be helpful to remove any ambiguity on this point by explicitly stating that mismatches arising as a consequence of the branch or head office jurisdiction not imposing tax are not intended to be caught by the branch payee mismatch rule.

23. Paragraph 25 of the Discussion Draft indicates that the branch payee mismatch rule should not apply unless the payment would have been included as ordinary income if it had been paid directly to the head office. This does not address issues of non-taxation in the head office jurisdiction that could arise from a number of causes other than geographical mismatch of the allocation (e.g., timing, base differences). Such issues were better addressed in the Action 2 Report, and any final guidance on branch mismatches should include at least the same level of clarity to ensure that countermeasures are targeted to the right cases, and not to the myriad situations where there are likely to be other mismatches between the tax base recognized in the head office and branch jurisdictions.

D. CFC inclusions and the impact on the application of the branch payee mismatch rule

24. The Discussion Draft states that "*the emphasis placed on the potential impact of CFC rules in the Action 2 Report may not be as relevant to the application of the branch payee mismatch rule where the recommended changes to domestic law, described at section 2.3 above, do not require any expansion of the scope of the CFC rules in the residence jurisdiction, however, the potential for economic double taxation could still arise where a diverted branch payment or payment to a disregarded PE is included in income under the CFC regime operating in the jurisdiction of a direct or indirect investor in the taxpayer*."

25. The view of the Alliance is that the second consideration outlined above strongly outweighs the first and we urge WP11 to recommend the inclusion of further guidance recommending that a branch payee mismatch will not arise where a payment is taken into account under the CFC rules in the parent jurisdiction. A CFC inclusion exception to the countermeasures for the disregarded branch and diverted branch payment structures, whether those countermeasures would take the form of a limitation on the branch exemption in the head office jurisdiction or a denial of the deduction in the payer jurisdiction, is clearly needed. To do otherwise would, as the Discussion Draft notes, give rise to economic double taxation. Moreover, failing to take account of CFC inclusions undercuts one of the fundamental aims of Action 2, which is to address deductions that are not matched by a corresponding inclusion.

26. While we note that the Discussion Draft does not recommend any changes to CFC rules, with the possible consequence that some branch payee mismatches may not be addressed by a CFC inclusion in the parent jurisdiction, it is difficult to see how this can be a justification for failing to take account of CFC inclusions that do in fact arise in jurisdictions that have adopted comprehensive CFC rules.

27. If the concern in this area arises from perceived difficulty in framing domestic law rules to take account of CFC inclusions, the Alliance notes that such provision has been made in the proposed UK domestic law anti-hybrid rules contained in the UK Finance Bill 2016. In broad terms, the draft UK legislation applies to counter D/NI mismatches arising where a deductible payment is not matched by a corresponding inclusion of "ordinary income" by the "payee". For these purposes, the definitions of "payee" and "ordinary income" are extended to include any person to whom a UK or foreign CFC charge arises as a consequence of the payment.[5]

28. If the concern in this area arises from perceived difficulty in determining when a deduction is matched by a corresponding CFC inclusion, this concern could be dealt with by putting the burden of proof on the taxpayer to demonstrate this fact.

E. Structured arrangements and control groups

29. Consultation question 3 and 24 in the Discussion Draft ask whether the branch payee mismatch and imported branch mismatch rules, respectively, should apply only to payments made under a structured arrangement or between members of the same control group. The view of the Alliance is that the rules should be restricted in this way, for the same reasons that apply to the proposals in the Action 2 Report. To be administrable, the rules should only apply where it is practicable for the parties to exchange information needed to comply with the rules without undue cost. In scenarios involving unrelated parties, the party claiming a deduction that could be disallowed under the branch payee mismatch or imported branch mismatch rules may not have sufficient knowledge (or access to knowledge) of the tax treatment of the payment in the hands of the recipient of the payment to be able to apply the rules appropriately.

30. In line with our recommendation above that the limitation on the branch exemption in the case of disregarded branch and diverted branch payment structures should only apply where the payment in question is deductible in the payer jurisdiction (i.e., where there is a risk of a D/NI outcome), we also recommend that the rule limiting the branch exemption should apply only to payments made under a structured arrangement or between members of the same control group.

IV. Deemed branch payment structures

31. Section 3 of the Discussion Draft addresses an internal mismatch in the form of a deemed branch payment that is deductible under the law of the branch jurisdiction but not recognized as includible under the law of the head office jurisdiction, in situations where the deduction is set off against non-dual inclusion income. It recommends, first, that the branch jurisdiction deny the deduction, and second, that

[5] See Section 259BB(6) (definition of "payee") and Section 259BD (extension of "ordinary income" to CFC inclusions) of the UK Finance Bill 2016.

the head office jurisdiction force an inclusion in income as a defensive measure if the branch jurisdiction has not denied the deduction.

32. We have already commented in paragraph 7 above on the anomaly between the treatment of deemed payments under the Action 2 Report and the treatment of deemed payments under this Discussion Draft. We believe that difference in treatment creates an undesirable conflict between the treatment of branches and subsidiaries.

33. The Discussion Draft does not address the difficulty that can arise in determining whether a deduction allowed by a branch jurisdiction is attributable to a deemed or notional payment from the branch to the head office or an allocation to the branch of a third party expense incurred by the entity. For example, where expenses are incurred at the head office on behalf of a branch, they could be reflected as deductible by the head office and offset by an internal charge to the branch (which would be a wash to the head office), or they could simply be reflected as deductible only by the branch, with no need to show a deduction or internal receivable at the head office. From the branch jurisdiction's perspective, there would be no need to determine whether the deduction is attributable to a notional internal or actual external expense, other than to apply this proposed anti-mismatch rule.

34. The type of mismatch described in this section is again one that would not exist if countries adopted the AOA and applied it consistently. For the reasons discussed above in connection with branch payee mismatch structures, we believe it is unwise to prescribe a new set of branch mismatch rule to be overlaid upon comprehensive existing recommendations in the AOA on how to allocate income and expenses between branches and head offices. Indeed, in the case where there is a treaty between the two countries, the Discussion Draft's recommended solutions to the "mismatch" may conflict with treaty obligations on the branch jurisdiction (to allow a deduction for the notional expense) or on the head office jurisdiction (not to tax income that is attributable to the branch). We believe any final guidance making recommendations in this are should discourage countries from attempting to override their treaty obligations through domestic law changes.

35. We note that the identification of the branch mismatch problem in the deemed payment case does not take into account the possibility that a branch jurisdiction may impose a "withholding" tax on a notional payment which may have the effect of ensuring a level of branch country taxation, notwithstanding the deduction in that country and the lack of inclusion in the head office jurisdiction. While such withholding taxes are not favored under the OECD Model Tax Convention, they do exist in some countries.[6] We believe that such withholding taxes should be taken into account in determining whether there is a D/NI outcome for purposes of any branch mismatch rule.

36. With respect to the exception for dual inclusion income, we believe that the Discussion Draft should more clearly state that the deemed payment problem will not arise in the case of an entity whose head office is located in a jurisdiction that applies a worldwide system of taxation subject to a foreign tax credit. The caveat expressed in paragraph 51 of the Discussion Draft ("unless the law of the branch jurisdiction permits a deduction in the branch to be set-off against income of another group entity in the

[6] See, e.g., the U.S. branch level interest tax under section 884(f)(1)(B) of the Internal Revenue Code.

branch jurisdiction") refers to an issue that can be dealt with appropriately under the Action 2 Report recommendations and does not provide a basis for invoking branch mismatch countermeasures.

37. We also note that the description of how this deemed payment countermeasure rule would work in the context of head office jurisdictions using the exemption method of double taxation relief, including the example after paragraph 48, appears to suggest the need for enormously precise coordination between the laws of the head office and branch jurisdictions in order to avoid any potential application of the countermeasure. Paragraph 49 refers to a situations that "ensures that the aggregate income of A Co under the laws of the residence and branch jurisdictions is equal to the entire net income of A Co". We believe this reflects a wholly unrealistic expectation about the level of precision that exists, or could be shown to exist, in calculating the interaction between the tax laws of two separate jurisdictions. It is worth noting that even Article 23, which is at the heart of the OECD Model Tax Convention's core objective to avoid double taxation, leaves a good deal of flexibility to a residence State in how it calculates its exemption obligation under that Article, provided that the general principle of exempting the relevant income is followed.[7] This recognizes that there is too much variation among countries' tax rules to expect a dollar for dollar, penny for penny reconciliation of any two countries' calculations. Moreover, the example shown is a simplistic one involving a single transaction. In real life, there are liable to be thousands if not millions of transactions that go into calculating the respective profits of the branch and home office, and it could involve a huge effort to try to determine through precise, individual calculations whether there is any daylight between the two jurisdictions' calculation of the net income in each location from each transaction.

38. We believe this is yet another issue that signals the need to give serious thought to the scope of any proposed rules countering supposed deemed payment mismatch situations. Such rules, if they are to exist at all, should address only clear and material mismatches attributable to easily identifiable conflicts between the laws of the two jurisdictions on the recognition of deemed payments. On balance, however, we do not believe the analysis in the Discussion Draft provides a sufficiently considered approach for recommending deemed payment mismatch countermeasures at this time.

V. DD branch payments

39. Section 4 of the Discussion Draft addresses situations with "DD outcomes" (i.e., "where the same item of expenditure is treated as deductible under the laws of more than one jurisdiction"). Some of the points made above for deemed payment situations (i.e., relating to the determination of dual inclusion income in a worldwide taxation system jurisdiction and the precision of the anticipated calculations required to determine whether the countermeasures apply) are equally applicable to this section.

40. We would also note that some countries already have rules in place to deal with DD situations. For example, the U.S. dual consolidated loss rules, enacted 30 years ago, were one of the first provisions in the world to address this type of problem, and they have been highly developed to operate as part of the U.S. tax system. Given the substantial uncertainties likely to arise under any new set of rules, particularly

[7] See, e.g., paragraph 43 of the Commentary on Article 23 of the OECD Model Tax Convention.

ones as sketchily drawn as those in the Discussion Draft, we would suggest that the final guidance should not encourage countries to replace long-established rules with a new set of proposals.

VI. Imported mismatch structures

41. See paragraphs 29 and 30 above for the IAPT's views on the application of control group and structured arrangement tests in the context of imported mismatch structures.

42. The negative implications of the deemed branch payment rules are particularly acute in the context of imported mismatch structures. Our comments at paragraph 7 above address the arbitrary difference in treatment between branches and subsidiaries that these proposed rules cause in jurisdictions that offer notional interest deductions. In a jurisdiction that offers a notional interest deduction for branches, the effect of the imported mismatch rules would be to deny a deduction where the branch has related party income, but not where the branch only has income from third parties. In either case there may be valid business reasons for the existence of the branch and the income being attributed to it (including the legitimate decision to take advantage of the notional interest deduction regime), and no "tax structuring" involved. In this scenario, it is difficult to see any principled justification for the application of the imported mismatch rules.

ANNEX II

Responses to the consultation questions in the Discussion Draft

1. Are there any practical issues that could arise in denying the benefit of the branch exemption for a payment that is disregarded, exempt or excluded from taxation under the laws of the branch jurisdiction?

Yes. See Section III.B and paragraph 32 in Annex I.

2. Are there any practical differences between reverse hybrids, on the one hand, and disregarded branch and diverted branch payment structures, on the other, that would justify a different approach to that set out in Chapters 4 and 5 of the Action 2 Report?

Yes. See Section III.A in Annex I.

3. Should the branch payee mismatch rule apply only to payments made under a structured arrangement or between members of the same control group?

Yes. See Section III.E in Annex I.

4. Are there any practical differences between hybrid entities and deemed branches and diverted branch payments that would justify modifying the scope of the rule or the guidance on the application of the structured arrangement rule to these types of branch mismatches?

We have not identified any practical differences in this area.

5. Do the above paragraphs provide a clear explanation of the intended interaction between the branch payee mismatch rule and the ordinary rules for allocating income to a branch (including any rules consistent with those set out in Section 2.3 limiting the scope of the branch exemption)?

No. See Section III.C in Annex I.

6. Should a payment to a branch be treated as included in income for the purposes of the disregarded branch or diverted branch payment rules if the payment is taken into account under the CFC rules in the parent jurisdiction?

Yes. See Section III.D in Annex I.

7. Do the paragraphs above provide a clear explanation of when a disregarded branch and diverted branch payment will be treated as having given rise to a mismatch in tax outcomes?

No. See Section III.C in Annex I.

8. What is the appropriate legal test for determining whether a payment made under a branch payee structure has given rise to a branch mismatch?

See Section III.C in Annex I.

9. What other guidance (if any) is required to explain the intended scope of the branch payee mismatch rule.

See Section III.C in Annex I.

10. Are there any practical differences between disregarded hybrid payments, on the one hand, and deemed branch payments on the other that would justify a different approach to that set out in Chapter 3 of the Action 2 Report?

Yes. See Sections II and IV in Annex I.

11. Are there any practical issues that could arise in applying the branch mismatch rules to a deemed payment between the branch and head office?

Yes. See Sections II and IV in Annex I.

12. Do you agree that a payment that is treated (for tax purposes) as made between the branch and head office but which, in practice, results in an allocation of third party expenses should be outside the scope of the deemed branch payment rule?

Yes, although see also Section IV in Annex I.

13. Do you agree that payments that represent or are calculated by reference to a third party expense should fall within the scope of the DD branch payment rules discussed in Section 4 below?

See response to Question 14 below.

14. Is it practical to distinguish between deemed and DD branch payments based on whether the notional payment is treated as an allocation of a third party expense by the taxpayer?

In the view of the IAPT, the proposals potentially give rise to a broad array of practical difficulties. See Sections IV and V in Annex I.

15. Do you agree that no mismatch arises (and no adjustment should be required) under the deemed branch payment rule if the rules in the branch or residence jurisdiction operate in such a way as to ensure that the total amount of the taxpayer's income will be brought into account in at least one jurisdiction?

Yes (or, indeed, if this outcome arises from the application of the CFC rules in the parent jurisdiction).

16. Are there any practical difficulties in determining the amount of dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

See response to Question 14 above.

17. Is further guidance required on the circumstances when the deemed branch payment rule should apply?

We believe that serious additional thought needs to be given to the scope of any proposed rules countering supposed deemed payment mismatch situations. Such rules, if they are to exist at all, should address only clear and material mismatches attributable to easily identifiable conflicts between the laws of the two jurisdictions on the recognition of deemed payments. On balance, however, we do not believe the analysis in the Discussion Draft provides a sufficiently considered approach for recommending deemed payment mismatch countermeasures at this time.

18 Do you agree that the primary rule in respect of deemed branch payments should be to deny the deduction in the jurisdiction where the payment is deemed to be made?

See response to Question 17 above and the comments in Section IV in Annex I.

19. What further guidance (if any) is required on implementation solutions for the identification of dual inclusion income in the context of these branch mismatch arrangements?

See response to Question 17 above and the comments in Section IV in Annex I.

20. Do you agree that a secondary or defensive rule is required to address any mismatch in tax outcomes that could otherwise arise where the payer jurisdiction does not apply the primary rule?

In principle, once workable rules have been designed, the universal application of those rules would be promoted if primary rules are supported by appropriate secondary or defensive rules. It is critical, however, to ensure first that the primary rule is not overly broad (as to which see our comments in Section III.B or Annex I on the proposed branch exemption rules) and that the interaction between primary and secondary rules is properly designed to ensure no overlap arises.

21. Do you agree that although these branch mismatch structures may not be thought of as "hybrid" they still fall within Recommendation 6 of the Action 2 Report and would be subject to adjustment under those rules?

Yes, in principle, subject to our detailed comments in Annex I.

22. Are there any practical difficulties in determining the amount of duplicate deductions and dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

In the view of the IAPT, the proposals potentially give rise to a broad array of practical difficulties. See Sections IV and V in Annex I.

23. Is further guidance required on the circumstances when Recommendation 6 should apply to DD branch payments?

Yes. See Sections IV and V in Annex I.

24. Should the imported branch mismatch rules apply only to payments made under a structured arrangement or between members of the same control group?

Yes. See Section III.E in Annex I.

25. Are there any practical differences between branch and imported mismatches that would justify modifying or clarifying the scope of the rule or the guidance on the application of the imported mismatch rule?

Yes. See Section VI in Annex I.

Document No.181
September 16, 2016

The International Co-operation and Tax Administration Division
Organisation for Economic Cooperation and Development

Accounting & Tax Committee
Japan Foreign Trade Council, Inc.

Comments on Discussion Draft on BEPS Actions 2 "Branch Mismatch Structures"

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) in response to the invitation to public comments by the OECD regarding the "BEPS Action 2 : Branch Mismatch Structures" released on August 22nd, 2016.

The JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of JFTC's Accounting & Tax Committee is to submit specific policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

* * *

[Overall comment]

We support the efforts of the OECD to set out recommendations for domestic rules designed to neutralize the branch mismatch by classifying hybrid branch mismatch structures such as deduction/no inclusion (D/NI) or double deduction (DD) into five basic types in this discussion draft, which would help to secure the fairness of competition among companies around the world by prohibiting some multinational entities from generating double non-taxation structures through overseas branches.

The suggestions in the discussion draft to neutralize the mismatch are based on the concept that domestic rules in income payee/payer countries should be improved, which is the same as the concept stated in the final report of BEPS Action 2. However, it should be noted that the effort to improve the domestic rules may result in inadvertent double taxation (denying deduction in one country & including in gross income in the other country) in some cases, if both of income payee/payer countries enhance their domestic rules to eliminate the double non-taxation, which would put excessive tax burden on multinational entities which are doing sound business activities with tax compliance mindset. Therefore, we would request that the “Linking-rule” should be applied in one country only in cases where deduction/tax-exemption in the other country is obvious.

Recommended improvements to the domestic rules for above 5 basic types of branch mismatch structures are classified into two different ways. One is to adjust the net income of the head office, and the other is to adjust the net income of the branches. As it is required for taxpayers to determine appropriately which way should be applied for each structure, it would take too much administrative burden to verify tax treatments of the transactions with branches. Therefore, we would like to request that it is further clarified to which cases “Branch payee mismatch rule” will be applied. For example, it would be a reasonable approach to limit the application of the rule only to cases where the mismatch arises, as stated in para.19-26 of this discussion draft.

Also, the questions related to the practical difference between “Reverse hybrids”, “Disregarded branch structure” and “Diverted branch payment structure” (as stated in “Question 2”) are seen in “Question for Consultation” of this discussion draft. If each country legislates the different tax treatment depending on these structures even though the practical difference of these three structures is vague, it is difficult for companies to determine the type of the structure they are taking, and company’s predictability for applying tax laws will be impaired. Therefore, we would like to request that the OECD recommends the participating countries that the adjustment rule for each structure should be clarified as much as possible to prevent arguments about how the rules are applied when the countries change their domestic rules. In addition, it should be also recommended that adjustment rules with regard to the relations between tax treaties and domestic tax laws are to be clarified as needed.

(End of comment)

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19 September 2016

Dear Mr. Pross,

BEPS Public Discussion Draft: Branch mismatch structures

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD's *Public Discussion Draft on Branch Mismatch Structures under Action 2 (Neutralising the Effects of Hybrid Mismatch Arrangements) of the BEPS Action Plan*.

We have made a number of general observations on the proposal and then gone on to consider each of the five types of 'branch mismatch' identified in the Discussion Draft and the recommendations associated with each of them.

General comments

1. We would note that the proposals contained in the original Action 2 final report on neutralizing the effects of hybrid mismatch arrangements are extremely complex as evidenced by the fact that the report extends to over 400 pages. The proposals contained in this Discussion Draft add further significant complexity. A number of the concerns raised in the Discussion Draft regarding branch mismatches may well be addressed or at least reduced through other parts of the BEPS Action Plan for example Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status. We believe therefore that consideration should be given to providing Member States with the option of implementing the recommendations addressing hybrid entities and hybrid instruments contained in the original Action 2 report but without the need to extend them to branches as contemplated in the Discussion Draft.

2. We would note that branches are very common for financial institutions. It is not uncommon for financial institutions to have a very large number of inter-branch transactions every year which have nothing to do with tax planning. Such transactions may well be subject to regulatory scrutiny. To avoid a disproportionate administrative burden for financial institutions we believe that consideration should be given to allowing Member States who chose to adopt the branch mis-match rules to exclude regulated entities from those rules.

Disregarded/ diverted branch structures

3. The Discussion Draft sets out a potential recommendation 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). It would appear that this recommendation is intended to apply to any payment (regardless of whether it is made within a controlled group or under a structured arrangement). This amounts to introducing a 'subject to tax test' in a Member State's branch exemption. This appears to be going significantly further than merely neutralizing hybrid mismatches and indeed would be inconsistent with the territorial (or quasi territorial) tax policies adopted by a number of Member States. To the extent such Member States feel the need to introduce some level of protection from base erosion this could be done by applying CFC rules to the branch. We believe therefore it may be more appropriate to limit the counter action in these cases to disallowing a deduction for payments made in a controlled group or under a structured arrangement (subject to the point noted below) where there is no income inclusion due to a branch mismatch.
4. If however a decision is taken to include a recommendation that treats a payment as being received directly by the head office we note that it will be important to also ensure that any related expenses are treated as incurred by the head office otherwise there will be the anomalous result that where the branch mismatch rules apply the head office jurisdiction is taxable on the gross receipt whereas had there been no mismatch the recipient would only be taxable (in either the branch or the head office) on the net profit.
5. To the extent there is a rule that denies a deduction for all payments made to a branch where there is no taxation in either the head office or the branch this would appear to give rise to a disallowance even in situations where, were the payment made to a company located in the jurisdiction of the branch no disallowance would arise under the main Action 2 recommendations . This could occur for example with branches in non taxing territories. Payments to companies located and carrying on business in a non taxing jurisdiction are generally not within the scope of the main Action 2 recommendations since the lack of taxation in the payee does not arise due to hybridity. Consideration should be given to addressing this inconsistent approach to branches and ensuring that there is no disallowance for a payment where had it been paid to a company located in the jurisdiction of the branch there would still have been no taxation for reasons other than hybridity.
6. Similarly, and as noted in the Discussion Draft, there should be an exception to the disallowance in cases where the head office jurisdiction would not tax the receipt irrespective of the existence of the branch.
7. We agree that inclusion of the income in a CFC calculation should be treated as giving rise to ordinary income.

8. We would also note that it will be important to ensure that the rules do not apply where the head office taxes worldwide income but grants a credit for any overseas tax suffered in the branch.

9. Finally, we note that on a practical level, in structured arrangements that involve third parties, it may be even harder for a payer to identify whether there is a mismatch than where the payment is to, say, a hybrid entity because the payer is unlikely to have knowledge of any internal branch allocation being carried out by the recipient. To avoid uncertainties on the application of the rule consideration could therefore be given to limiting the application of the branch mismatch rules to payments within a controlled group.

Deemed branch payments

10. We agree with the Discussion Draft that in the deemed branch payments recommendations care will need to be taken to ensure that mere differences in the method of profit attribution between a branch and its head office do not give rise to mismatches (where none exists in reality).

Double deduction (DD) branch payments

11. The Discussion Draft sets out a recommendation to apply the Action 2 Report in such a way that the primary response would be for the head office territory to deny duplicate deductions unless they are set against dual inclusion income.

12. This could potentially result in branch losses becoming stranded, which would seem to go beyond the scope of the BEPS objectives. If the recommendation were instead to be that there should be a disallowance of the deduction in the head office jurisdiction if and only if the deduction is set off against non dual inclusion income in the branch location, this would mean that relief remains available in the head office jurisdiction for branch losses (which have not been deducted locally).

13. We note here that a number of jurisdictions already have 'dual consolidated loss rules' which deny a deduction for losses which are also deductible overseas. It will be important that Member States are given sufficient flexibility where necessary to ensure that any double deduction branch payment rules may be implemented in a manner consistent with those existing rules.

Imported branch mismatches

14. We are reminded that the BEPS Action Plan broadly sought to ensure that the tax burden in a jurisdiction reflected the activities and value added in that jurisdiction. Where there is a perceived erosion of the tax base(s) as a result of a mismatch in the tax treatment of a transaction (or entity), the logical focus would be on the recipient jurisdiction taxing the receipt or for the ultimate parent jurisdiction taxing the sum under CFC/ remittance rules. The denial of a deduction is a suitable proxy alternative only where the expense in question is an expense which would not otherwise have been incurred were it not for the no or low taxation on the recipient side. To deny deductions in other circumstances seems to ignore the fundamental objective of the hybrid rules to stop the use of hybridity to give rise to deductions that would not otherwise have arisen. The imported mismatch rules risk shifting the tax burden to the jurisdiction that is paying expenses that it would have incurred whatever the taxation in the recipient jurisdiction (or further up the chain). This creates a reallocation of taxing rights that does not align with the location of substance and value driving activities. Consideration should be given to limiting the application of the imported mismatch rule to situations where an expense is being incurred that would not otherwise have arisen but for the existence of the hybrid mismatch arrangement. We would note that this

suggestion applies equally to the imported mismatch proposals in the original Action 2 report as it does to the recommendations in the Discussion Draft.

15. There is however an additional point that can be made regarding the imported mismatches as they apply to branches. The taxation of branches often requires the head office and/ or the branch jurisdiction to determine whether the activities in the branch rise to the level of a permanent establishment for the purposes of a treaty. This is often a difficult question. The imported mismatch rule requires a tax payer to potentially identify the tax treatment of an arrangement in four separate jurisdictions (payer jurisdiction, payee jurisdiction, branch jurisdiction and head office jurisdiction). It also potentially requires knowledge of the treaty analysis in the head office and branch jurisdictions. Taken together this clearly creates a significant burden for tax payers. Consideration should therefore be given to allowing Member States to ‘opt out’ from the application of the imported mismatch rules to branch situations.

For any clarification of this response, please contact the undersigned or any of the contacts below. We look forward to discussing any questions you have on the points we raise above or on other specific matters raised by respondents to the Discussion Draft and would welcome the opportunity to contribute to the discussion as part of the public consultation meeting in October.

Yours faithfully,

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UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

September 16, 2016

VIA EMAIL

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Re: USCIB Comment Letter on OECD's Discussion Draft on BEPS Action 2 – Branch Mismatch Structures

Dear Mr. Pross,

USCIB[1] appreciates the opportunity to comment on the discussion draft concerning BEPS Action 2 Branch Mismatch Structures (discussion draft).

Interaction with worldwide foreign tax credit system

As an organization representing primarily US business, USCIB views this discussion draft through that prism. Despite years of discussion concerning the possibility of moving to a territorial system, the United States still taxes worldwide income, takes into account worldwide losses, and relieves double taxation through the granting of a foreign tax credit that is generally computed on a worldwide – not a country-by-country or item-by-item -- basis. The discussion draft generally fails to address whether the proposed rules would apply in a country that does not apply an exemption system and if the rules were to apply, how they would work.

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

With respect to the outbound case, where, for example, the US is the residence country and the branch is elsewhere, none of the proposals should apply. There should be a general statement in the final report that there is no need for any primary or secondary rule when the residence jurisdiction taxes on the basis of worldwide income. We see two places where this needs to be addressed.

First, the deemed branch payment rules should make clear that if the residence country taxes ALL income of the branch, that is good enough, and the country does not need to adopt a rule that selectively taxes the deemed payment. It is important that a branch jurisdiction does not inappropriately disallow a deduction merely because there is no rule explicitly including the deductible payment, since all the income of the branch will be included in the taxable income of the corporation resident in a jurisdiction that taxes on the basis of worldwide income (all income will be dual inclusion income). Failure to allow the deduction will double count the income and create the likelihood of double taxation.

Paragraph 51 addresses this in part. It provides: "deemed branch payments are unlikely to give rise to significant issues where the residence jurisdiction treats the income of the branch as taxable (and grants a credit for foreign taxes paid by the branch) …. The residence jurisdiction may also take further measures to ensure that any credits that arise in respect of foreign taxes paid by the branch are in respect of income that is taxable under the laws of both jurisdictions." The first sentence quoted above should be stronger. Deemed branch payments will not give rise to significant issues where the residence jurisdiction treats the income of the branch as taxable. The second sentence quoted above, although clearly not mandating any rule, seems to imply that a country-by-country limitation would be consistent with the branch mismatch principles and a worldwide limitation would possibly not be considered consistent. This is excessive. Despite the BEPS project, countries retain tax sovereignty. If the income is included in the US base and subject to a net basis taxation at the US rate, then the mechanics of the US foreign tax credit rules should not change that result.

Second, the DD rule, which is designed to disallow duplicative losses, should not apply if the residence country has its own rules that accomplish the same result. The US has dual consolidated loss rules[2] as do several other countries. These rules have existed for a long period of time, have been carefully thought through over that period, and were designed with the US system particularly in mind and they should therefore not be disturbed.

With respect to the inbound case, the proposals are consistent with the longstanding US position with respect to its triangular branch rule in treaties and internal rules such as regulations under IRC section 882. The final report should make clear that those rules are not to be disturbed under the proposals.

[2] Adopted as part of the Tax Reform Act of 1986.

As noted above, USCIB is concerned about the discussion draft's failure to consider how its rules would interact with worldwide/foreign tax credit systems. This problem is not new; the same lack of coordination is apparent in the Action 2 Final Report on Hybrids. A few examples of that lack of coordination are highlighted below[3].

Recommendation 2.1 (page 45 of the final report) provides that a country that grants a dividend exemption should not grant the exemption to the extent that the dividend is deductible under foreign law and "Equally, jurisdictions should consider adopting similar restrictions for other types of dividend relief granted to relieve economic double taxation on underlying profits." If the US does not change its deemed foreign tax credit rules, then the recommendation is for the foreign jurisdiction to deny the deduction, which would of course increase foreign tax credits.

The hybrid rules do not count a CFC inclusion that carries an entitlement to an FTC (page 30 of the hybrid final report) as an inclusion, so a US CFC inclusion would never count as "inclusion" for purposes of applying the deduction/no inclusion standard. If a US shareholder had an inclusion, it would have an "entitlement" to a credit and the despite the inclusion at the US shareholder level (or whether foreign tax credits were in fact available), the underlying instrument would be treated as a hybrid financial instrument and potentially the deduction would be denied which would create both circularity (how would the credit be computed?) and double taxation, there **is** both an inclusion and a denial of a deduction.

There are many cases in the final report when an inclusion only counts as an inclusion if the foreign tax credit is computed on an item-by-item basis, so again a US inclusion (this could be a dividend as opposed to a CFC inclusion) would not "count" and the other country would be directed to deny the deduction.

The treaty section of the Final Report also raises issues concerning the interaction of the hybrid rules with worldwide/foreign tax credit systems. Paragraph 446 is in Chapter 15 of the Final Report, which is the Chapter that considers the interaction between the recommended changes to domestic law (in Part 1 of the Report) and the provisions of the OECD Model Tax Convention, provides: "double non-taxation situations may arise in the application of the credit method *by reasons of treaty or domestic law provisions that either supplement, or depart from, the basic approach of Article 23 B (Credit Method) of the OECD Model Tax Convention (OECD, 2014*). One example would be domestic law provisions that allow the foreign tax credit applicable to one item of income to be used against the State of residence's tax **payable on another item of income**." (Emphasis added.) The US of course does not follow the OECD Model's approach in Article 23B. That approach is at best a per country approach and possibly could be read as an item-by-item approach, while the US applies a worldwide foreign tax credit limitation.

[3] Other places where the interaction with a worldwide/foreign tax credit system is implicated but not fully addressed include: Recommendation 1, paragraph 5 (c); paragraph 32 the definition of ordinary income; paragraph 414.

Paragraph 446 goes on to say that: "These are other situations where contracting states should ensure that their tax treaties provide for the elimination of double taxation without creating opportunities for tax avoidance strategies." While this language does not recommend or mandate any changes to domestic law, it weighs heavily against cross-crediting of any sort and may invite other countries to consider that the mere possibility of cross-crediting should be considered to mean that income is not included in taxable income in the residence country and therefore a deduction may be appropriately denied.

Also, as USCIB pointed out in our letter on the hybrid discussion draft, cross-crediting does not provide a benefit unless there are high taxes elsewhere in the group, so the ultimate effect of cross-crediting is not to create double non-taxation, but -- in the case of a US taxpayer claiming a foreign tax credit in the US -- for the US fisc to subsidize high foreign taxes in other countries. That is, if 100% of the foreign source income is included in the US tax base that income will be subject to 35% tax (certainly not low or no-taxation). Whether that tax is made up of foreign tax that includes some cross-crediting or not should not matter if the goal is avoiding double non-taxation. To the extent that there is low-taxed income isolated somewhere else in the group (income not included in the US return) -- that ought to be an issue for other aspects of the BEPS project. Is it appropriately there (transfer pricing, CFC rules)? Is there harmful tax competition? Excess interest deductions? But cross-crediting as a policy decision ought not to objectionable.

Countries may choose to relieve double taxation through an exemption/territorial system or a foreign tax credit system. Either of these choices is appropriate. Further, the Commentary on Article 23 leaves a great deal of flexibility to States on the details of calculating relief under either the exemption or the credit method. Paragraph 32 of the Commentary provides: "The two Articles are drafted in a general way and do not give detailed rules on how the exemption or credit is to be computed, this being left to the domestic laws and practice applicable."[4]

A foreign tax credit system is a more precise method of relieving double taxation and will generally result in less untaxed income. Countries that have a foreign tax credit system need to balance the potential for cross-crediting with the administrative burden imposed by very restrictive foreign tax credit rules. If countries have a sovereign right to choose an exemption/territorial system, then they may also appropriately choose a worldwide credit even though that might permit some cross-crediting of taxes from a high-tax jurisdiction against income earned in a low-tax jurisdiction. There are a range of reasonable choices from which sovereign countries may choose to eliminate double taxation and they do not need to choose the narrowest option.[5] The branch mismatch rules should not imply that a foreign tax credit

[4] See also, Article 23 Commentary, paragraphs 43 and 62, which defer to the domestic law of each State given the wide variety of fiscal policies and techniques.

[5] Countries using the exemption method face similar balancing concerns between theoretical purity and administrative convenience. If, for example, a country prescribes a "haircut" of 5% against otherwise exempt income, would the country be required to compute the expenses actually attributable to exempt income to ensure that deductions are not over-allocated to non-exempt income? If the "haircut" misallocates expenses, then under

system needs to operate on country-by-country basis, which would be inconsistent with the deference the OECD Model Commentary affords to each State's domestic law under Article 23.

Complexity and interaction with profit attribution to permanent establishments

The branch mismatch discussion draft sensibly recommends rules that would produce results that are based on the Action 2 Final Report. To provide different rules would produce inconsistent results, which would undercut the purpose of the Action 2 Final Report. Nevertheless, it is important to recognize that the level of complexity of the Action 2 Final Report is astonishing. USCIB understands that one of the reasons this level of complexity was deemed acceptable was that in many cases taxpayers make deliberate use of hybrid instruments and entities for tax planning purposes and therefore the hoped for result is that the use of hybrid instruments and entities would decline significantly and the complex rules would rarely apply.

Branches are different, especially in light of the new rules concerning when a permanent establishment exists. At least in the short term, companies will face significant uncertainty concerning whether they have a branch and how profit will be attributed to branches. Countries have not uniformly accepted either the 2010 AOA or the 2008 AOA or any standard at all for attributing profit to branches.

In the absence of an agreed standard for attributing profit, the level of coordination that is implied by the discussion draft seems as if it will be difficult if not impossible to reach and would strain the resources of both tax administrations and taxpayers in attempting to do so.

Respect for true branches

The problems noted above on complexity and profit attribution, are especially critical in the context of true branches. The discussion draft needs to strike a better balance between the goal of preventing the use of deemed branches to produce inappropriate tax results, and the need to avoid unpredictable and unworkable consequences for multinational businesses that conduct foreign operations, for reasons unrelated to taxes, through "true" branches (*i.e.*, branches whose existence and substance is recognized both in the country where the branch is located and in the enterprise's home country). This is particularly a concern for regulated financial services companies that, for capital efficiency reasons, often operate in branch form outside the US.

The discussion draft appears to be premised on the belief that all differences between the allocation of an item of income or expense for branch country tax purposes and the allocation of the same item for home country tax purposes are problematic. This belief is oversimplified and unrealistic. Differences in the rules governing the attribution of particular items of interest

a theoretically pure model too much income may be considered exempt. The rules are not intended to cut this fine.

and other expenses are pervasive and for the most part inoffensive. Particularly in the context of true branches, where inconsistencies between different national tax systems are almost inevitable, the existence of those inconsistencies should not, by itself, be sufficient to justify the application of remedial principles.

To the extent the discussion draft extends beyond fact patterns involving hybrid branches, and branches that are deemed to exist from the perspective of one country's tax rules but not another's, it is critically important to avoid unintended and unfair consequences for true branches. The OECD should provide an exception for transactions entered into in the ordinary course of business by true branches, or, at the very least, for true branches of financial services companies that are subject to significant prudential regulation.

The OECD should also consider an exemption from these rules for "true branches" as the result of tax policies that are appropriately designed to facilitate investment. That is, whether policy choices that are designed to spur local investment are appropriate should be determined based on whether those policies constitute harmful tax competition under Action 5. If a tax benefit designed to spur investment passes muster under Action 5, then countries should not use other tools – including branch mismatch rules -- to undercut that country's legitimate policy choice.

Sincerely,

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