Public Discussion Draft

BEPS ACTION 2
BRANCH MISMATCH STRUCTURES

22 August 2016

OECD
BETTER POLICIES FOR BETTER LIVES

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22 August 2016

BEPS ACTION 2 - DISCUSSION DRAFT ON BRANCH MISMATCH STRUCTURES

The Report on Neutralising the Effects of Hybrids Mismatch Arrangements (Action 2 Report)[1] sets out recommendations for domestic rules designed to neutralise mismatches in tax outcomes that arise in respect of payments under a hybrid mismatch arrangement. The recommendations in Chapters 3 to 8 of that report set out rules targeting payments made by or to a hybrid entity that give rise to one of three types of mismatches:

(a) *deduction / no inclusion (D/NI) outcomes*, where the payment is deductible under the rules of the payer jurisdiction but not included in the ordinary income of the payee;

(b) *double deduction (DD) outcomes,* where the payment triggers two deductions in respect of the same payment; and

(c) *indirect deduction / no inclusion (indirect D/NI) outcomes,* where the income from a deductible payment is set-off by the payee against a deduction under a hybrid mismatch arrangement.

The report includes specific recommendations for improvements to domestic law intended to reduce the frequency of such mismatches as well as targeted hybrid mismatch rules which adjust the tax consequences in either the payer or payee jurisdiction in order to neutralise the hybrid mismatch without disturbing any of the other tax, commercial or regulatory outcomes.

This discussion document identifies and analyses mismatches that can arise through the use of branch structures and sets out preliminary recommendations for domestic rules, based on those in the Action 2 Report, which would neutralise the mismatches in tax outcomes arising from the use of these structures.

The CFA invites interested parties to comment on the preliminary recommendations set out in this document and to provide input on the "Questions for Consultation" highlighted at the end of each section in order to facilitate the analysis of the issues covered by the discussion draft. Responses should be sent by email to aggressivetaxplanning@oecd.org in Word format, by no later than **19 September 2016**. They should be addressed to the International Co-operation and Tax Administration Division, OECD/CTPA.

Please note that all responses to this consultation document will be made publicly available. Responses submitted in the name of a collective "grouping" or "coalition", or by any person submitting responses on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

The views and proposals included in this discussion draft do not represent consensus views of the Committee on Fiscal Affairs or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment. It is considered that stakeholder comments are essential to advancing this work.

[1] OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (Action 2 Report).

BRANCH MISMATCH STRUCTURES

DISCUSSION DRAFT

1. Introduction

1.1 Action 2 Report

1. The Report on Neutralising the Effects of Hybrids Mismatch Arrangements (Action 2 Report)[2] sets out recommendations for domestic rules designed to neutralise mismatches in tax outcomes that arise in respect of payments under a hybrid mismatch arrangement. The recommendations in Chapters 3 to 8 of that report set out rules targeting payments made by or to a hybrid entity that give rise to one of three types of mismatches:

(a) *deduction / no inclusion (D/NI) outcomes*, where the payment is deductible under the rules of the payer jurisdiction but not included in the ordinary income of the payee;

(b) *double deduction (DD) outcomes*, where the payment triggers two deductions in respect of the same payment; and

(c) *indirect deduction / no inclusion (indirect D/NI) outcomes*, where the income from a deductible payment is set-off by the payee against a deduction under a hybrid mismatch arrangement.

2. The report includes specific recommendations for improvements to domestic law intended to reduce the frequency of such mismatches as well as targeted hybrid mismatch rules which adjust the tax consequences in either the payer or payee jurisdiction in order to neutralise the hybrid mismatch without disturbing any of the other tax, commercial or regulatory outcomes.

1.2 Branch mismatches

3. This discussion document identifies and analyses mismatches that can arise through the use of branch structures. These branch mismatches occur where the residence and the branch jurisdictions (i.e. the jurisdictions in which the head office and branch are located) take a different view as to the allocation of income and expenditure between the branch and head office and include situations where the branch jurisdiction does not treat the taxpayer as having a taxable presence in that jurisdiction. Branch mismatch arrangements can be used to produce the same types of mismatches that are targeted by the recommendations in the Action 2 Report. For example:

(a) a deductible payment made to a branch may not be brought into income in either the branch or residence jurisdiction (a D/NI outcome analogous to that described in Chapters 4 and 5 of the Action 2 Report);

(b) a branch may make (or be treated as making) a deductible payment to the head office that is not taken into account in calculating the net income of the head office under the laws of the residence jurisdiction (a D/NI outcome analogous to that described in Chapter 3 of the Action 2 Report);

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[2] OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (Action 2 Report).

(c) the same item of expenditure may be treated as deductible under the laws of both the residence and the branch jurisdictions (a DD outcome analogous to that described in Chapters 6 and 7 of the Action 2 Report); or

(d) the income from a payment may be offset against a deduction under a branch mismatch arrangement (an indirect D/NI outcome analogous to that described in Chapter 8 of the Action 2 Report).

4. Branch mismatch arrangements are not "hybrid" in the sense that they are not the result of differences in the tax treatment or characterisation of an instrument or entity. They are, however, closely aligned to the hybrid entity mismatches described in Chapters 3 to 8 of the Action 2 Report in that they result from differences in the way the residence and branch jurisdiction treat payments made by or to the branch or head office. In light of their similar structure and tax consequences, WP11 has been considering the need for branch mismatch rules that would bring the treatment of these arrangements into line with the recommendations set out in the Action 2 Report.

1.3 Public discussion document

5. Branch mismatches arise where the ordinary tax accounting rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer falling out of the charge to taxation in both the branch and residence jurisdiction. This discussion document identifies five basic types of branch mismatch arrangements:

(a) ***Disregarded branch structures*** where the branch does not give rise to a permanent establishment (PE) or other taxable presence in the branch jurisdiction;

(b) ***Diverted branch payments*** where the branch jurisdiction recognises the existence of the branch but the payment made to the branch is treated by the branch jurisdiction as attributable to the head office, while the residence jurisdiction exempts the payment from taxation on the grounds that the payment was made to the branch;

(c) ***Deemed branch payments*** where the branch is treated as making a notional payment to the head office that results in a mismatch in tax outcomes under the laws of the residence and branch jurisdictions;

(d) ***DD branch payments*** where the same item of expenditure gives rise to a deduction under the laws of both the residence and branch jurisdictions; and

(e) ***Imported branch mismatches*** where the payee offsets the income from a deductible payment against a deduction arising under a branch mismatch arrangement.

6. Sections 2 – 5 below describe these branch mismatch arrangements in further detail and set out preliminary recommendations for domestic rules that would neutralise the mismatches in tax outcomes arising from the use of these structures. While the operation and scope of these branch mismatch rules, follows the general approach set out in the Action 2 Report, the trigger for the application of the rules is different. The recommendations in the Action 2 Report target mismatches that are attributable to differences in the legal characterisation of instruments and entities. Branch mismatches do not generally result from differences between the branch and residence jurisdictions in their interpretation of the legal structure adopted by the taxpayer, rather they are the result of differences in the way the branch and head office account for a payment made under that structure. Because branch mismatches turn on differences in tax accounting rather than legal characterisation, the same basic branch structure may call for the application of different branch mismatch rules, depending on the accounting treatment adopted by the

branch and head office. However, as for the recommendations under the Action 2 Report, the intention of these rules is to comprehensively neutralise any mismatch in tax outcomes arising from the use of branch structures (regardless of the accounting treatment applied in the branch or head office) while avoiding the risk of economic double taxation or disturbing any of the other tax, commercial or regulatory outcomes.

7. The recommendations set out in this discussion document do not necessarily reflect the consensus views of WP11 or the Committee of Fiscal Affairs on the appropriate treatment of branch mismatches. Members of the public are invited to comment on the preliminary recommendations set out in this document and are specifically requested to provide input on the "Questions for Consultation" highlighted at the end of each section. All comments submitted before 19 September 2016 will be published on the OECD website and considered by WP11 at a meeting to be held in October this year.

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

8. The first category of mismatches considered in this paper are D/NI outcomes that arise where the residence jurisdiction treats a deductible payment as received through a foreign branch (and therefore excludes or exempts the payment from ordinary income) while the branch jurisdiction does not tax the payee because:

(a) in the case of a disregarded branch structure, the payee has an insufficient presence in the branch jurisdiction to be taxable on such payment; or

(b) in the case of a diverted branch payment the branch jurisdiction exempts or excludes the payment from taxation on the grounds that the payment is treated as made to the head office.

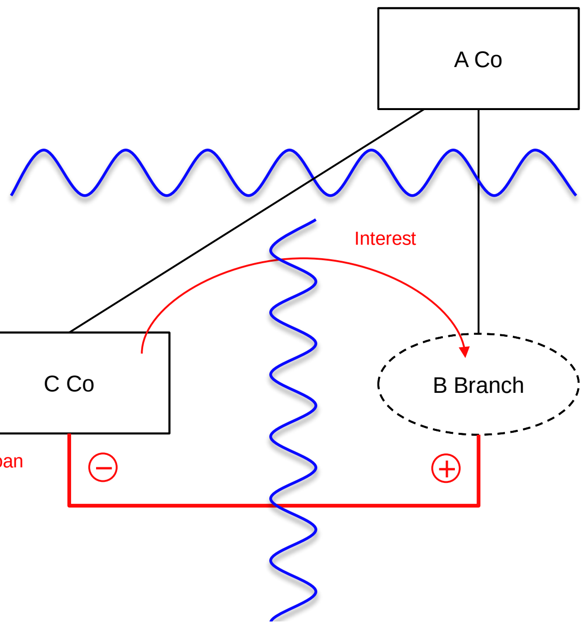
Both these structures are discussed in further detail below.

2.1 Disregarded branch structure

9. In a disregarded branch structure the mismatch arises due to the fact that a deductible payment received by a taxpayer is treated, under the laws of the residence jurisdiction, as being made to a foreign branch (and therefore eligible for an exemption from income) while the branch jurisdiction does not recognise the existence of the branch and therefore does not subject the payment to tax. An example of a disregarded branch structure is illustrated in the figure below.

Figure 1

Disregarded Branch Structure



10. 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. Country A exempts or excludes the interest payment from taxation on the grounds that it is attributable to a foreign branch. The interest income is not, however, taxed in Country B because A Co does not have a sufficient presence in Country B

to be subject to tax in that jurisdiction. The payment of interest therefore gives rise to an intra-group mismatch (a D/NI outcome).

11. The D/NI mismatch that results from a disregarded branch structure can arise in a number of ways and could be a product of the domestic rules operating in each jurisdiction or due to a conflict between domestic law and treaty requirements. For example:

(a) the interest payment could be treated as income of a foreign branch (and therefore tax exempt) under Country A's domestic law but may not be included in income under Country B's domestic law because the branch does not give rise to a taxable presence in Country B for domestic law purposes;

(b) the branch could be treated as constituting a PE under the Country A-B tax treaty so that Country A is required to exempt the interest payment from tax under a provision equivalent to Article 23A of the Model Tax Convention[3] (even though the branch does not give rise to a taxable presence under Country B's domestic law); or

(c) the branch may not meet the legal definition of a PE under the Country A-B tax treaty so that the payment of interest received by the branch is excluded from taxation by Country B under relevant provisions of that treaty (even though Country A's domestic law allows A Co to treat the payment as income of a foreign branch that is, accordingly, exempt from tax in Country A).

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

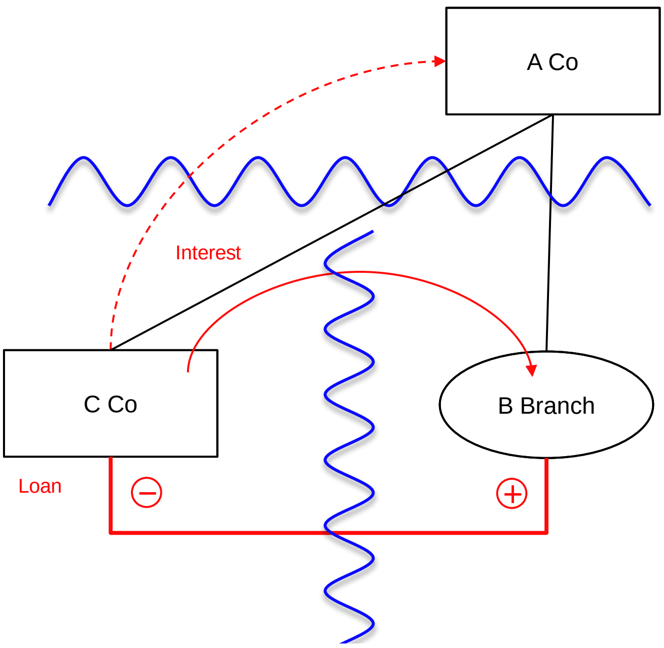
2.2 Diverted branch payment

12. A diverted branch payment has the same structure and outcomes as a payment to a disregarded branch except that the mismatch arises, not because of conflict in the characterisation of the branch, but rather, due to a difference between the laws of the residence and branch jurisdictions in the attribution of payments to the branch. An example of a diverted branch payment is illustrated in the figure below. This example is the same as that described in Section 2.1 above except that both the residence and branch jurisdictions recognise the existence of the branch. The mismatch arises due to the fact that the branch treats the interest payment as if it was paid directly to the head office in Country A, while the head office continues to treat the payment as made to the branch. As a consequence, the payment is not subject to tax in either jurisdiction (a D/NI outcome).

[3] OECD Model Tax Convention on Income and Capital: Condensed Version 2014, OECD Publishing, Paris. (Model Tax Convention).

Figure 2

Diverted Branch Payment



13. This mismatch in tax treatment could be due to a difference in the rules used by Countries A and B for allocating income to the branch (or a difference in the interpretation or application of those rules) or due to specific rules in Country B that exclude or exempt this type of income from taxation at the branch level due to the fact that the payment is made to a non-resident. As with the disregarded branch structures, the mechanism by which the mismatch in tax outcome arises is similar to that of a reverse hybrid in that both the residence and the branch jurisdictions exempt or exclude the payment from taxation on the basis that it should properly be regarded as received in the other jurisdiction.

2.3 Recommended Rules

Limiting the scope of the branch exemption

14. The simplest way to prevent a D/NI outcome from arising in respect of branch payee structures would be for the residence jurisdiction to restrict the scope of the branch exemption so that it does not cover payments that have not been brought into account for tax purposes by the branch. In line with Recommendation 5.1 of the Action 2 Report, this discussion draft therefore recommends that the residence jurisdiction consider making improvements to the operation of the branch exemption so that payments that are disregarded, exempt or excluded from taxation under the laws of the branch jurisdiction are treated as if they had been received directly by the head office (and thus outside the exemption for branch income).

15. While limiting the ambit of the branch exemption in this way will have the effect of reducing the number of mismatches that arise in respect of payments made under these types of branch structures, this recommendation is not specifically targeted at neutralising branch mismatches and would apply regardless of whether the payer was eligible to claim a deduction for the payment or whether the payment was made under a structured arrangement or within the confines of a controlled group. Requiring the taxpayer to

bring a payment into account for tax purposes in the residence jurisdiction when that payment is not included in ordinary income by the branch, will not automatically trigger an additional tax liability. For example, under this rule a payment, such as a dividend, that was not taxed at the branch level (and was therefore required to be brought into account for tax purposes by the head office) may still be eligible to benefit from a tax exemption or other type of tax relief in the residence jurisdiction that is provided for payments of that nature under domestic law (such as a participation exemption for foreign dividends).

16. As with Recommendation 5.1 of the Action 2 Report, this recommendation is designed 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, while preserving the ability of jurisdictions to determine the scope of their taxing jurisdiction consistent with their general system of taxation. It should also be noted that, in certain cases, the residence jurisdiction may be prevented from limiting the scope of the branch exemption in cases where the tax treaty in effect between the residence and branch jurisdictions contains a provision equivalent to Article 23A of the Model Tax Convention.[4]

Question for Consultation

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?

Branch payee mismatch rule

17. Branch payee structures such as those described at Sections 2.1 and 2.2 above do not fall within the literal language of the reverse hybrid rule in Chapter 4 of the Action 2 Report. That rule applies only to a payee that is *transparent* under the laws of the establishment jurisdiction.[5] A payee is treated as transparent, for these purposes, where the laws of the establishment jurisdiction permit or require that person to allocate or attribute its ordinary income to its investor/s.[6] In the case of branch payee structures, the recipient of the payment is not treated as transparent (either under the laws of the branch or the residence jurisdiction) and the income is not allocated to an investor in the payee but to another jurisdiction in which the payee is a taxpayer.

18. Given the similarity between reverse hybrid and branch payee structures, this discussion draft recommends that the payer jurisdiction adopt a branch payee mismatch rule, in line with the recommendations in Chapter 4 of the Action 2 Report, which would deny a deduction for a diverted branch payment or a payment made to a disregarded branch if the branch structure gives rise to a mismatch in tax outcomes. The particular features of this rule and its relationship to the reverse hybrid rule in Chapter 4 of the Action 2 Report are described in further detail below. Introducing a branch payee rule that is similar in operation and scope to the reverse hybrid rule will ensure that both rules operate together in a coherent and co-ordinated way and prevent taxpayers responding to the introduction of the reverse hybrid rule by switching to branch payee mismatch structures in order to secure the same tax advantages.

4 As noted in para 444 of the Action 2 Report: 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.

5 *Hybrids Report* (OECD, 2015), Recommendation 4.2.

6 *Hybrids Report* (OECD, 2015), para 160.

Question for Consultation

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?

(a) Branch payee mismatch rule should only apply to payments made under a structured arrangement or between members of the same group

19. The branch payee mismatch rule should only apply to payments made under a structured arrangement or between members of the same group. In order to ensure consistency, the tests for structured arrangement and control group should be the same as those set out in the Action 2 Report. This would mean that a taxpayer was not required to make an adjustment under the branch payee rule unless the payment was made to a person within the same control group or the payer was a party to a structured arrangement that was designed to produce a branch mismatch. As stated in the Action 2 Report:[7]

> "A person will be a party to a structured arrangement when that person has a sufficient level of involvement in the arrangement to understand how it has been structured and what its tax effects might be. A taxpayer will not be treated as a party to a structured arrangement, however, where neither the taxpayer, nor any member of the same control group, was aware of the mismatch in tax outcomes or obtained any benefit from the mismatch."

20. Example 4.1 of the Action 2 Report provides an illustration of the application of the reverse hybrid rule to an interest payment made by unrelated third party. In that case, the example notes that the use of a reverse hybrid as a special purpose lending vehicle (SPV) may indicate that the arrangement between the investor and SPV has been engineered to produce a mismatch in tax outcomes. In that example, however, the payer is not treated as a party to that structured arrangement because it pays a market rate of interest under the loan and would not have been expected, as part of its ordinary commercial due diligence, to take into consideration the tax position of the counterparty when making the decision to borrow money. The same analysis and outcomes that apply to the reverse hybrid structure described in Example 4.1 should also apply to a similar example involving a diverted branch payment or a payment to a disregarded branch.

Questions for Consultation

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

[7] Action 2 Report OECD (2015) para 342.

(b) Branch payee mismatch rule should only apply where there is a mismatch under the ordinary rules for allocating branch income

21. While the branch payee mismatch rule is the primary (and, in effect, only) rule for neutralising these types of branch mismatches – this rule will not be triggered in the payer jurisdiction unless the payment actually gives rise to a D/NI outcome. As noted in paragraph 149 of the Action 2 Report, in respect of reverse hybrids: "If the payment is brought into account as ordinary income in at least one jurisdiction then there will be no mismatch for the rule to apply to."

22. Accordingly, as with the reverse hybrid rule, the disregarded branch or diverted branch payment rules 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 will be the case where the mismatch has been neutralised by a rule in the branch or head office jurisdiction which ensures that payment that is not brought into account in one jurisdiction must be brought into account in the other. This would include any rule, consistent with the specific recommendation set out in section 2.3 above, that restricted the scope of the branch exemption in the residence jurisdiction to payments that had been included as income of the branch.

23. Paragraph 150 of the Action 2 Report states that a payment that has been 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 reverse hybrid rule. By treating the mismatch as neutralised by the inclusion of ordinary income under a CFC regime in the parent jurisdiction, the Action 2 Report reconciles any potential conflict between Recommendations 4.1 and 5.1 and eliminates the risk of double taxation that could otherwise arise from the simultaneous operation of a CFC charge and a reverse hybrid rule in the investor and payer jurisdictions.

24. 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. WP11 will, therefore, give further consideration to the need for any guidance on the potential impact of a CFC inclusion on the application of the branch payee mismatch rule.

Questions for Consultation

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)?

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?

(c) Rule should only apply if the mismatch is attributable to differences in the tax treatment of the branch under the laws of the two jurisdictions

25. The purpose of the branch mismatch rule is to neutralise mismatches caused by differences in the allocation of income between the branch and head office under the laws of the branch and residence jurisdictions. As is the case for the reverse hybrid rule, 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. Example 4.1 of the Action 2 Report provides an illustration of this principle in respect of an interest payment to a reverse hybrid. The example concludes that the reverse hybrid rule will not apply in cases where the investor is a tax exempt entity that would not have been subject to tax even if the payment had been made directly to the investor. The analysis and the outcomes described in that example would be the same in the context of a diverted branch payment or a payment to a disregarded branch where the taxpayer was tax exempt under the laws of the residence jurisdiction. Chapter 5 of the Action 2 Report sets out a counterfactual test for determining when a payment can be said to give rise to a hybrid mismatch under the reverse hybrid rule. The Action 2 Report treats a payment that gives rise to a D/NI outcome as a hybrid mismatch if the same payment would have been included in ordinary income if it had been made directly to the investor.[8] This counter-factual test would need to be adapted to fit the branch mismatch context, where the mismatch arises, not due to a conflict in the identification of the person receiving the payment but in the jurisdiction in which the payment is treated as received.

26. As with the reverse hybrid rule, this branch mismatch rule should not, however, be used to circumvent the operation of the hybrid financial instrument rule and this rule should continue to apply to the extent a direct payment would have been subject to adjustment under Recommendation 1 of the Action 2 Report.[9]

Questions for Consultation

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?

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?

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

[8] See Action 2 Report para 166.

[9] See Action 2 Report (OECD 2015) para 167 and Example 4.4.

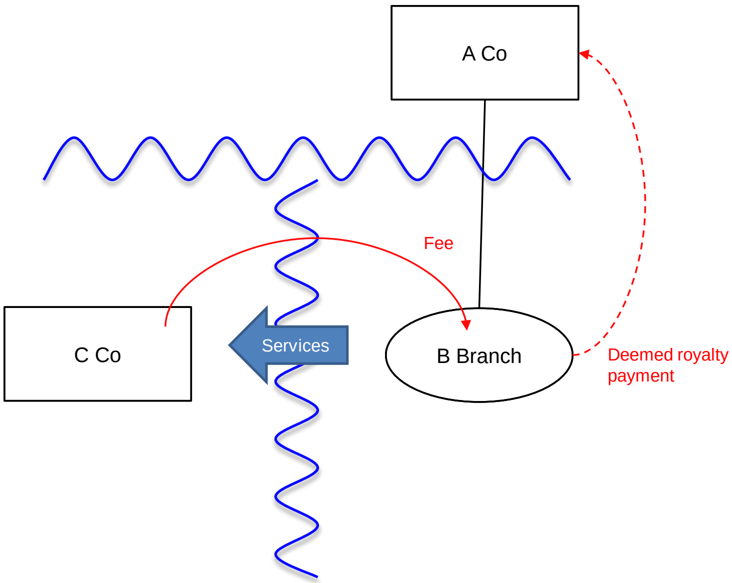
3. Deemed branch payments

27. In the case of diverted or disregarded branch payments discussed above, the mismatch arises in respect of a deductible payment made by a third party that is not included in income in either the branch or residence jurisdiction. It is also possible, however, to generate an internal mismatch between the branch and the head office by exploiting rules that allow the taxpayer to recognise a deemed payment between the branch and the head office in circumstances where there is no corresponding adjustment to the net income in the payee jurisdiction to recognise the effect of this deemed payment.

28. A structure illustrating a deemed branch payment is set out in the figure below. In this example A Co supplies services to a related company (C Co) through a branch located in Country B. The services supplied by the branch exploit underlying intangibles owned by A Co. Country B attributes the ownership of those intangibles to the head office and treats the branch as making a corresponding arm's length payment to compensate A Co for the use of those intangibles. This deemed payment is deductible under Country B law but is not recognised under Country A law (because Country A attributes the ownership of the intangibles to the branch). Meanwhile, the services income received by the branch is exempt from taxation under Country A law due to an exemption or exclusion for branch income in Country A.

Figure 3

Deemed Branch Payment



29. The deemed payment will give rise to an intra-group mismatch (a D/NI outcome) to the extent the deduction is set-off against branch income which is exempt from tax in Country A (non-dual inclusion income). A variation on this structure could result in the deemed payment giving rise to a loss in the branch which is set-off against the income of another group company in Country B (under a tax grouping regime, for example). While the structure illustrated above involves a deemed royalty payment, the tax or accounting principles as well as the application of transfer pricing principles in the branch jurisdiction can also give rise to other deemed payments (such as interest) with similar tax consequences.

30. This mismatch is similar to the one that arises in respect of a disregarded hybrid payment described in Chapter 3 of the Action 2 Report. In that case a hybrid payer (a person that is treated as a separate entity under the laws of the payer jurisdiction but as transparent or disregarded by the payee) makes a deductible payment that is disregarded under the laws of the payee jurisdiction due to the transparent tax treatment of the payer. The deduction resulting from that payment is then set-off against income that is not subject to tax in the payee jurisdiction (i.e. against non-dual inclusion income).

31. The mechanics of, and outcomes resulting from, deemed branch and disregarded hybrid payments are substantially the same. The branch is entitled to a deduction for an item that is treated as expenditure under the laws of the payer / branch jurisdiction but that is disregarded in the payee / residence jurisdiction because the payee does not treat the payer as a separate entity for tax purposes. The deduction that is attributable to the mismatch is then set-off against non-dual inclusion income, giving rise to a mismatch in tax outcomes.

3.1 Recommended branch mismatch rule

32. Given the similarity between disregarded hybrid and deemed branch payments, this discussion draft recommends countries introduce rules neutralising the effect of these arrangements that are consistent with the requirements set out in Chapter 3 of the Action 2 Report. The deemed branch payment rule would apply to:

- 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);
- where the resulting deduction was eligible to be offset against non-dual inclusion income.

As discussed further below, the primary response to the branch mismatch described in paragraph 28 above should be to deny the deduction for the deemed branch payment to the extent it exceeds dual inclusion income. In the event the branch jurisdiction does not introduce branch mismatch rules in line with these recommendations, then the residence jurisdiction should, as a defensive measure, include such payment in ordinary income to the extent necessary to eliminate the mismatch. The particular features of this rule and its relationship to disregarded hybrid payments rule are described in further detail below.

33. As with the branch payee structures discussed in Section 2 above, introducing branch mismatch rules that are similar in operation and scope to the disregarded hybrid payment rule will ensure that both sets of rules will operate together in a coherent and co-ordinated way and prevent taxpayers responding to the implementation of the recommendations in Chapter 3 of the Action 2 Report by switching to branch structures that provide them with the same tax advantages.

Question for Consultation

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?

Extending the recommendations to cover notional payments between branch and head-office

34. In the case of deemed branch payments, the deduction results from a notional payment between two parts of the same entity rather than an actual payment between separate entities. This means that deemed branch payment structures do not fall within the operation of the disregarded hybrid payment rule.

The Action 2 Report specifically excludes notional payments from the scope of the rules by defining a payment as: [10]

> "…any amount capable of being paid including (but not limited to) a distribution, credit, debit, accrual of money *but it does not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between the parties*." (emphasis added)

35. The payments that are treated as occurring between the branch and head office will be notional payments for legal purposes (even though they may be documented and result in actual transfers of cash between the branch and head office). Any comprehensive approach to addressing branch mismatches therefore needs to include these type of notional payments to the extent they give rise to a mismatch in tax outcomes.

36. Deemed payments are treated as outside the scope of the Action 2 Report because the deduction attributable to these items does not relate to an actual expense of the taxpayer. Deemed interest deductions and other similar regimes (such as allowances for equity capital) are specific tax concession designed to lower the effective 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. As such, these type of notional payments were not considered to produce a mismatch in tax outcomes in the sense contemplated by Action 2. The Action 2 Report further notes, however, that notional interest deductions, and rules having similar effect, should be considered further in the context of the implementation of the hybrids recommendations.[11]

37. Deemed branch payments can be distinguished from other types of notional payments in that they form part of a calculation that is intended to arrive at an accurate determination of the income that is subject to tax in the relevant jurisdiction and any mismatch resulting from the failure to recognise this type of deemed payment is a product of differences between the rules used in branch and residence jurisdictions for calculating and apportioning income and expenditure between the branch and head office. The deemed payment recognised in the payer jurisdiction generally should correspond to a genuine transfer of value between the branch and the head office that is indistinguishable, in policy terms, from an actual payment made by a disregarded hybrid entity where both the payer and the payment are ignored under the laws of the payee jurisdiction. The distinction between deemed and actual payments that led to WP11 excluding notional payments from the scope of the hybrid mismatch rules does not, therefore, apply to deemed branch payments and, accordingly, it is appropriate to extend the concepts developed in Chapter 3 of the Action 2 Report to cover these type of payments despite that fact that they do not fall within the strict definition of payment set out in the Action 2 Report.

Question for Consultation

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?

Definition of deemed payment

38. A deemed payment is any payment that is treated, under the laws of the payer jurisdiction, as a purely notional payment to the same taxpayer in another jurisdiction. A deemed payment should not

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10 Action 2 Report (OECD, 2015), definition of "payment" in Recommendation 12.

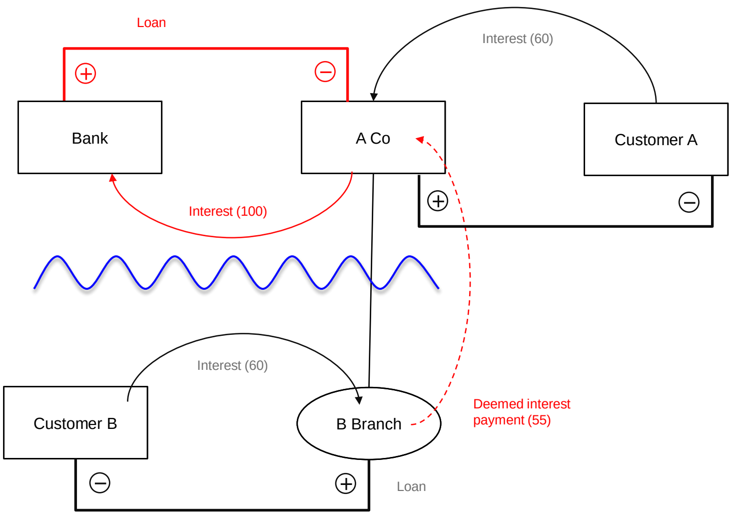
11 Action 2 Report, (OECD, 2015), para 11.

include any notional payment to the extent it represents or is calculated by reference to a third party expense of the taxpayer. A payment that is treated (for tax purposes) as made between the branch and head office but which, in practice, represents an allocation of third party expenses should be treated as outside the scope of the deemed branch payment rule. Note, however, that any such allowance for third party expenses could be subject to adjustment under the rules dealing with branch DD payments discussed in section 4 below.

39. The example below illustrates how the deemed branch payment rule should be applied in the context of a notional payment between the head office and branch. In this example A Co is a company established and resident in Country A. A Co borrows money from an unrelated bank and on-lends half of the borrowed funds to a customer located in Country A (Customer A). A Co lends the remaining portion of the funds to a customer located in Country B (Customer B) through a branch established in that country (B Branch).

Figure 4

Allocation of Interest Expense



40. Country B law calculates the net income of B Branch as if it was a separate entity for tax purposes. In making this calculation Country B treats B Branch as making an interest payment to the head office. While this payment is treated, under the laws of Country B, as a notional payment, in practice the payment is calculated by reference to a certain percentage of A Co's external borrowing costs. Accordingly the interest expense claimed under Country B law should *not* be treated as a deemed payment for the purposes of the deemed branch payments rule as it represents (in reality) an allocation by the taxpayer of third party interest costs to the branch. Such interest payment could, however, give rise a branch DD outcome as discussed further in Section 4 below.

41. Similarly a deemed interest payment between the branch and the head office should not be subject to adjustment under this rule to the extent the payment made by B Branch corresponds to an actual

allocation of third party interest expense by the head office under Country A law. This situation can be illustrated by varying the facts in the example above so that the rules in Country A for allocating income and expenditure to the branch require the head office to treat a portion of the interest paid to the bank as attributable to the exempt branch (and therefore non-deductible under Country A law). The table below illustrates the intended operation of the deemed branch payment rule in these circumstances.

Country A			Country B		
	Tax	**Book**		**Tax**	**Book**
<u>Income</u>			<u>Income</u>		
Interest from Customer A	60	60			
Interest from Customer B	-	60	Interest from Customer B	60	-
<u>Expenditure</u>			<u>Expenditure</u>		
Interest paid to bank	(50)	(100)	Deemed interest paid to head office	(55)	-
Net return		20	Net return		-
Taxable income	10		Taxable income	5	

42. As shown in this table A Co earns a total of 120 of interest income and has 100 of interest expense. The net income under the arrangement is therefore 20. Under Country B law the B Branch is treated as taxable on the interest payment of 60 from Customer B and is entitled to a deduction for the deemed interest expense of (55) on a hypothetical loan from the head office calculated without reference to the taxpayer's actual interest expense. The net income subject to tax in Country B is therefore 5.

43. Under Country A law, the head office of A Co is treated as deriving 60 of taxable interest income. The interest paid by Customer B is eligible for the branch exemption and not subject to tax under Country A law. A Co is, however, required to allocate half the interest expense on the bank loan to the exempt branch for tax purposes so that the total amount of interest that is deductible under Country A law is only (50) leaving the head office with net taxable income under Country A law of 10.

44. The net effect of this arrangement is that while A Co's total net income under the arrangement is 20, A Co has a taxable income of 15 under the laws of Country A and B.

45. In this case a portion of the notional interest treated as paid by the branch to the head office under Country B law (50) is recognised in the residence jurisdiction by virtue of the corresponding interest allocation made by the head office to the branch under the laws of Country A. No adjustment would be required under the deemed branch payment rule to the extent the notional payment (under Country B law) corresponds to the allocation of an actual expense under the rules of the residence jurisdiction (Country A law). The net effect of the tax treatment of the branch and the head office under the laws of Country A and B result in (50) of the notional payment being taxed as an agreed allocation of third party expense. The deemed branch payment rule will continue to apply, however, to the extent the notional

interest paid to the head office was not recognised through a corresponding allocation of third party interest expense in Country A. Accordingly, in this example, only a portion (5) of the notional interest expense would be caught by the deemed branch payment rule.

46. Unlike hybrid mismatch arrangements, where the distinction between disregarded and deductible hybrid payments is based on the legal form of the arrangements, the distinction between the deemed and DD branch payment rules turns on the accounting and tax treatment adopted by the branch and head office and the transfer pricing adjustments that are used for arriving at an accurate assessment of the net income in each jurisdiction. Given that these calculations and adjustments are made by the same taxpayer there does not appear to be any immediate difficulty in determining whether the DD or deemed branch payment rule should be applied and either rule will be sufficient to neutralise the mismatch. WP11 may give further consideration, however, to developing more detailed rules on the intended application of the branch mismatch rules in the case of deemed and DD branch payments and provide more detailed guidance on the appropriate outcomes in each case.

Questions for Consultation

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?

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?

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?

No mismatch if the deduction is set-off against dual inclusion income

47. As in the case of disregarded hybrid payments, no mismatch arises (and no adjustment should be required) where the rules in either the branch or residence jurisdiction operate in such a way as to ensure that the amount of deemed branch payments will not exceed the amount of dual inclusion income. This means that these types of mismatch are unlikely to arise where there is a mechanism in place in either the branch or residence jurisdiction for ensuring that the total amount of net income subject to tax in both jurisdictions is no less than the total net income of the taxpayer as a whole.

48. The following example illustrates a situation where mechanisms for calculating branch income ensure that any deemed deduction will be set-off against dual inclusion income. This example is the same as illustrated in Figure 4 except that the rules for allocating income and expenditure in the residence jurisdiction allow the head office a deduction equal to the net income of the branch. The table below illustrates the intended operation of the deemed branch payment rule in these circumstances.

Country A			Country B		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Interest from Customer A	60	60			
Interest from Customer B	60	60	Interest from Customer B	60	-
Expenditure			Expenditure		
Interest paid to bank	(100)	(100)	Deemed interest paid to head office	(50)	-
Adjustment for net income of branch	(10)		Adjustment under deemed branch payment rule	-	
Net return		20	Net return		-
Taxable income	10		Taxable income	10	

49. In this example, A Co earns a total of 120 of interest income and has 100 of interest expenses. The net income under the arrangement is therefore 20. Under Country A law, A Co takes into account the whole of A Co's income and expenditure but allows the head office to claim a deduction for the net amount of branch income recognised under Country B law. This results in an (adjusted) net income of 10 under Country A law and 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.

50. In effect, by allowing a deduction for only the net income recognised under Country B law Country A ensures that the deduction for the deemed payment to head office will always be set-off against income that is subject to tax under Country A law (i.e. dual inclusion income) and thereby prevent any mismatch from arising in respect of the deemed payment. If, however, the rules in Country A permit A Co to claim a deduction for the net income of the branch that is, in fact, greater than the taxable income, a mismatch in tax outcomes could arise as a result of a deemed payment.

51. The fact that no mismatch arises unless the deduction is set-off against non-dual inclusion income also means that 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) 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 branch jurisdiction. 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.

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

Denial of the deduction in the branch jurisdiction

52. As in the case of disregarded hybrid payments, the most appropriate and effective way to neutralise the mismatch that arises in respect of a deemed branch payment will be to restrict the deduction for the deemed payment to the amount of dual inclusion income.[12] To the extent a deduction is denied in the branch jurisdiction it should be eligible to be carried-forward under ordinary rules.[13] As for the disregarded hybrid payment rule, countries would be encouraged to identify appropriate implementation solutions that preserve the intended outcomes under the deemed branch payments rule while avoiding unnecessary complexity.[14] It will generally be the case that accounts showing the income and expenditure of the taxpayer will have been prepared under the laws of both jurisdictions using domestic tax concepts. Tax administrations should use these existing sources of information and tax calculations as a starting point for identifying deemed branch payments and whether the resulting deduction has been set-off against dual inclusion income.

Questions for Consultation	
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?
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?

Include the payment in income in the residence jurisdiction

53. If the payer jurisdiction does not neutralise the mismatch by restricting the deduction for the deemed branch payment to the amount of dual inclusion income then, consistent with the defensive rule in Recommendation 3.1(b) of the Action 2 Report, the residence jurisdiction should treat the deemed payment as ordinary income to the extent that the payment gives rise to a branch mismatch. As with the primary rule, countries are encouraged to identify appropriate implementation solutions. To avoid double taxation these solutions may include deferring the income inclusion until the resulting deduction is, in fact, offset against non-dual inclusion income.

Question for Consultation	
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?

[12] Action 2 Report (2015 OECD) Recommendation 3.1(a).

[13] Action 2 Report (2015 OECD) Recommendation 3.1(d).

[14] Action 2 Report (2015 OECD) para.130-1.

4. DD branch payments

54. DD outcomes arise where the same item of expenditure is treated as deductible under the laws of more than one jurisdiction. These type of mismatches give rise to tax policy concerns where the laws of both jurisdictions permit the deduction to be offset against income that is not taxable under the laws of the other jurisdiction (i.e. against non-dual inclusion income).

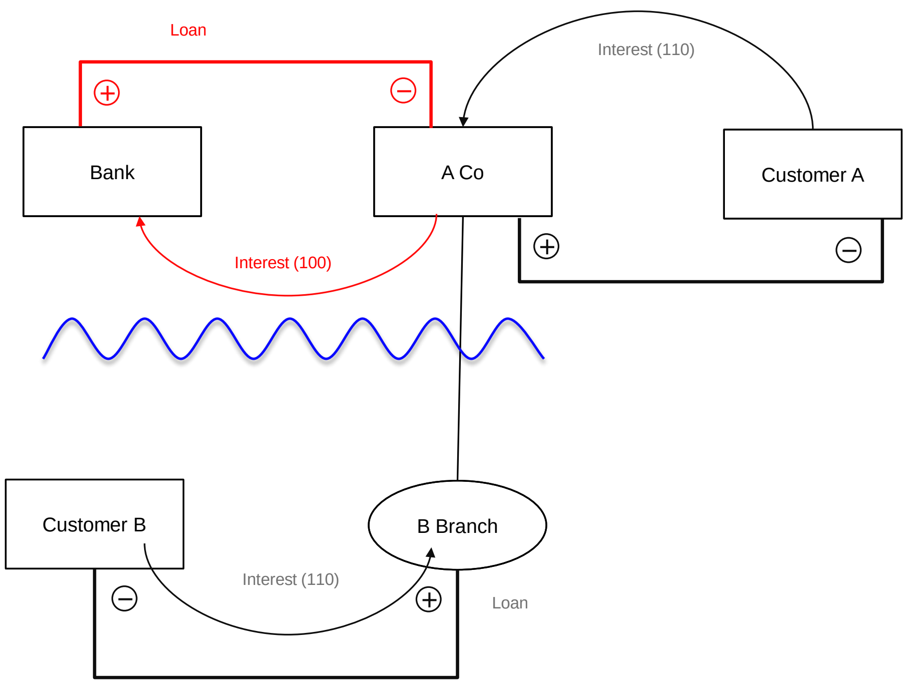
55. The Action 2 Report contemplates that the recommendations in Chapter 6 would extend to DD outcomes involving the use of branch structures. A DD outcome involving a payment by a branch is illustrated in Example 6.2 of the Action 2 Report. In that example the taxpayer establishes a PE in the branch jurisdiction and arranges for the PE to borrow money from a local bank. Interest on the loan is deductible in both the residence and branch jurisdictions. The example concludes that the interest payment will be subject to the deductible hybrid payments rule unless there are rules preventing the payment from being set-off against non-dual inclusion income.

4.1 Application of Recommendation 6 to DD branch payments

56. Branch structures can give rise to DD outcomes in cases where the rules for allocating income and expenditure between the branch and the head office allow the taxpayer to claim a deduction for the same expenditure item under the laws of the branch and residence jurisdictions and the general exemption for branch profits provided by the residence jurisdiction means that the deduction in the branch jurisdiction is set-off against income that is not subject to tax in the residence jurisdiction (i.e. against non-dual inclusion income). An example of this type of structure is illustrated in the figure below.

Figure 5

DD Branch Structure



57. This example is similar to that described in Figure 4 above. A Co is a company established and resident in Country A and has lent money to a customer located in Country A (Customer A). A Co borrows additional funds from a bank and uses those funds to make a loan to a customer located in Country B (Customer B) through a branch established in that country (B Branch). Income attributable to the branch is exempt or excluded from Country A taxation under Country A domestic law or under the Country A-B tax treaty.

58. In this case the domestic rules governing allocation of interest expense result in a DD outcome because:

- Country A applies a fungibility approach to the deduction of interest expenses which results in half the amount of the interest expense on the loan being deductible under Country A law; and

- The domestic law of Country B allows the branch to apply a tracing approach which results in the full amount of the interest expense on the same loan being deductible under Country B law.

The table below illustrates the resulting mismatch in tax outcomes:

Country A			Country B		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Interest from Customer A	110	110			
Interest from Customer B	-	110	Interest from Customer B	110	-
Expenditure			Expenditure		
Interest paid to bank	(50)	(100)	Interest paid to bank	(100)	-
Net return		120	Net return		-
Taxable income	60		Taxable income	10	

59. As shown in this table A Co earns a total of 220 of interest income and has (100) of interest expense. The net income under the arrangement is therefore 120.

60. Under Country A law, the head office of A Co is treated as deriving 110 of taxable interest income. The interest paid by Customer B is eligible for the branch exemption and not subject to tax under Country A law. A Co is entitled to a deduction for the interest expense on the bank loan, however, half of this expense is allocated to the exempt branch, so that the total amount of deductible interest expense under Country A law is only (50) leaving the head office with net taxable income under Country A law of 60.

61. Under Country B law the branch is treated as taxable on the interest payment from Customer B and is entitled to a deduction for the interest expense on the entire amount of the loan from the bank, leaving the branch with net taxable income of 10. A Co therefore has net income for book purposes of 120

but taxable income of only 70. This indicates that up to 50 of interest deductions are being set-off against non-dual inclusion income.

62. The mechanics of the structure and the resulting tax outcomes are the same as those described in Chapter 6 of the Action 2 Report on deductible hybrid payments in that the structure relies on the taxpayer claiming a deduction for the same item under the laws of two jurisdictions and a mechanism that allows the deduction in the branch jurisdiction to be offset against income that is not dual inclusion income (in this case, the branch exemption in Country A). Although the above branch mismatch structure may not be thought of as "hybrid", in the sense that there is no difference in the tax characterisation of the taxpayer under the laws of Countries A and B, they still give rise to a mismatch that falls within the existing recommendations in the Action 2 Report and would be subject to adjustment under those rules as described further below.

A Co is a hybrid payer under Recommendation 6.2

63. The definition of a *hybrid payer* under Recommendation 6.2 focuses on the treatment of the taxpayer in respect of a particular item of expenditure rather than the hybrid nature of the taxpayer itself. The Recommendation states:[15]

> *A person will be treated as a hybrid payer in respect of a payment that is deductible under the laws of the payer jurisdiction where:*
>
> > *(a) the payer is not a resident of the payer jurisdiction and the payment triggers a duplicate deduction for that payer (or a related person) under the laws of the jurisdiction where the payer is resident (the parent jurisdiction);*

64. In this case A Co claims a deduction for the payment under the laws of Country B (the payer jurisdiction) and the payment triggers a duplicate deduction under the laws of Country A (the parent jurisdiction), which is the country where A Co is resident. A Co therefore falls within the definition of hybrid payer to the extent that the interest payment gives rise to a DD outcome. In this case, while A Co has claimed a deduction for the full amount of the interest expense in Country B, only half of this payment is deductible under Country A law, so the interest payment therefore gives rise to a duplicate deduction of (50) which is subject to adjustment under Recommendation 6.1.

A hybrid mismatch arises to the extent the deduction is set-off against non-dual inclusion income

65. Recommendation 6.1(c) provides that no mismatch will arise to the extent that a deduction is set-off against an amount that is included in income under the laws of both the parent and the payer jurisdictions (i.e. dual inclusion income). In this case, however, because of the operation of the branch exemption in Country A, none of B Branch's income is subject to tax in Country A in the relevant period.

Application of the primary response

66. In this case, it is the residence jurisdiction that should apply the primary response. Country A should deny A Co's duplicate deductions to the extent it gives rise to a mismatch in tax outcomes. The table below sets out the required adjustment under the rule.

[15] Action 2 Report (OECD, 2015) Recommendation 6.2(a).

Country A			Country B		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Interest from Customer A	110	110			
Interest from Customer B	-	110	Interest from Customer B	110	-
Expenditure			Expenditure		
Interest paid to bank	(50)	(100)	Interest paid to bank	(100)	-
Adjustment	50				
Net return		120	Net return		-
Taxable income	110		Taxable income	10	

67. The head office would be entitled to carry the denied interest deduction forward in accordance with its ordinary domestic rules and this deduction would be available to be set-off against future dual inclusion income. Such dual inclusion income could arise, for example, where the rules for allocating income and expense to the branch and the head office resulted in the same item of income being treated as taxable under the laws of both jurisdictions.

Application of the defensive rule

68. In the event Country A does not apply the primary response, Country B should deny B Branch a deduction for the payment to the extent necessary to prevent that deduction from being set-off against income that is not dual inclusion income. The total amount of adjustment required under Country B law would be calculated as follows:

Country A			Country B		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Interest from Customer A	110	110			
Interest from Customer B	-	110	Interest from Customer B	110	-
Expenditure			Expenditure		
Interest paid to bank	(50)	(100)	Interest paid to bank	(100)	-
			Adjustment	50	
Net return		120	Net return		-
Taxable income	60		Taxable income	60	

69. As for Recommendation 6 of the Action 2 Report (and the deemed branch payment rule described above) countries would be encouraged to identify appropriate implementation solutions that preserve the intended outcomes under these rules while avoiding unnecessary complexity. Tax administrations should use existing sources of information and tax calculations as a starting point for identifying DD outcomes and determining whether the resulting deduction has been set-off against dual inclusion income.

4.2 Further guidance on the application of Recommendation 6 to DD branch outcomes

70. WP11 could provide further commentary and guidance on the application of the recommendations in Chapter 6 of the Action 2 Report to DD branch outcomes. Clarifying the operation of Recommendation 6 in the context of branch mismatch structures should improve the transparency and certainty of outcomes under this recommendation while ensuring these structures are not used by taxpayers to engineer DD outcomes.

Questions for Consultation

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?

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?

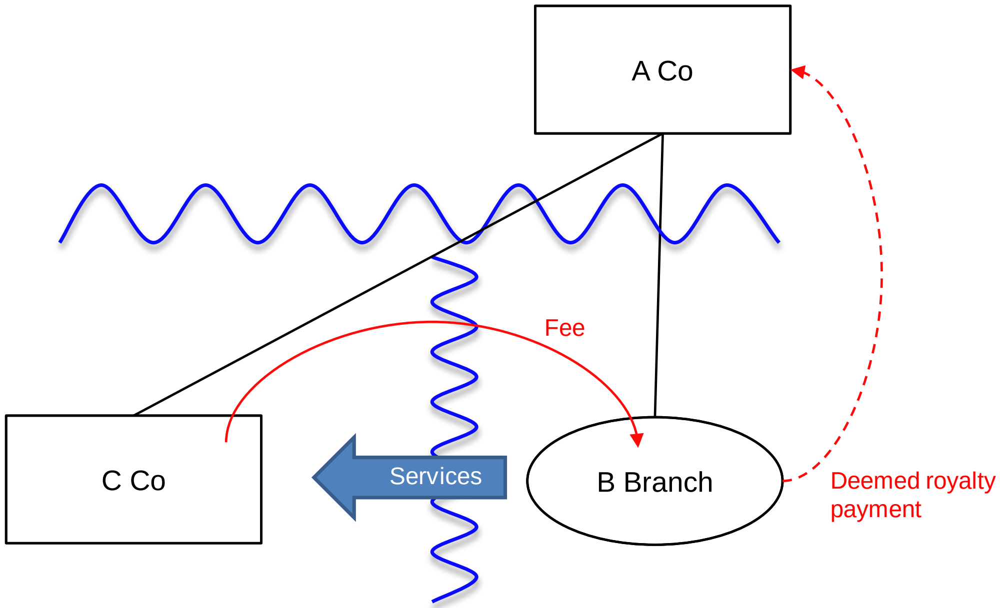
23. Is further guidance required on the circumstances when Recommendation 6 should apply to DD branch payments?

5. Imported branch mismatches

71. An imported branch mismatch can arise where a person with a deduction under a branch mismatch arrangement offsets that deduction against a taxable payment received from a third party. An example of imported branch mismatch is illustrated in the figure below. This example is based on the one described in Section 3 above (deemed branch payments) except that C Co is a subsidiary of A Co and it is assumed that there is no rule in either Country A or B addressing the mismatch in tax outcomes arising from the notional payment. As a consequence, the (deductible) service fee paid by C Co (which is treated as exempt under Country A law) is offset against a deduction under a branch mismatch arrangement resulting in an indirect D/NI outcome.

Figure 6

Imported Branch Mismatches



72. The structure is similar to the imported mismatch structures described in Recommendation 8 of the Action 2 Report in that it relies on the taxpayer engineering a mismatch (in this case a branch mismatch) under the laws of two jurisdictions and importing the effect of that mismatch into a third jurisdiction through a plain-vanilla instrument with otherwise orthodox tax treatment.

73. These structures raise similar tax policy issues to those identified in the Action 2 Report in that the most appropriate and effective way to neutralise the mismatch is for either or both Country A and B to implement rules neutralising the mismatch. However, in order to maintain the integrity of the other recommendations, an imported mismatch rule is needed to deny the deduction for any payment that is directly or indirectly set-off against any type of branch mismatch payment.

5.1 Imported mismatch rule should apply to branch mismatches

74. If WP11 recommends rules designed to bring the treatment of branch mismatches into line with the recommendations set out in the Action 2 Report then the principles applying to imported mismatches set out in Chapter 8 of that report could also be extended to cover branch mismatch structures. In this way the treatment of imported mismatches would be the same regardless of whether they arose through the use

of a branch or hybrid mismatch structure and the guidance in the Action 2 Report on tracing and priority, in respect of imported mismatch rules operating in each jurisdiction, could be used to determine the extent to which the payment has been set-off against a branch mismatch.

5.2 Application to structured arrangement and members of the same group

75. The imported branch mismatch rule should only apply to payments made under a structured arrangement or between members of the same group. In order to ensure consistency, the tests for "structured arrangement" and "control group" should be the same as those set out in the Action 2 Report and in line with the treatment of branch payees discussed in Section 2 above. This would mean that a taxpayer was not required to make an adjustment under the imported branch mismatch rule unless the payment was made to a person within the same control group or the payer was a party to an arrangement designed to produce that branch mismatch.

Questions for Consultation

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

ANNEX - SUMMARY OF 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?

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?

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

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)?

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?

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?

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?

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

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?

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?

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?

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?

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?

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?

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?

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

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?

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?

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?

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?

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?

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

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?

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?