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.