USCIB UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL

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

Dear Mr. Pross,

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

Interaction with worldwide foreign tax credit system

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Complexity and interaction with profit attribution to permanent establishments

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

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

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

Respect for true branches

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

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

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

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

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

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

Sincerely,

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