Kluwer International Tax Blog

Permanent Establishments: Never a dull moment

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Tuesday, September 20th, 2016

Tax practitioner's in the northern hemisphere taking their summer holidays may well have included the OECD discussion draft of 5 July 2016 on the attribution of profits to permanent establishments as part of their holiday reading (a mere 40 pages). See post on July 21, 2016. Over 50 organisations and individuals submitted comments(published by the OECD on 9 September 2016) totalling more than 400 pages on the draft. With one exception, all submissions were from the northern hemisphere. Move over Leo Tolstoy!

Branch mismatch structures

If this was not enough on permanent establishments to think about over the summer, on 22 August 2016, the OECD published a Public Discussion Draft on Branch Mismatch Structures, to follow up their work on BEPS Action 2 (Neutralising the Effects of Hybrids Mismatch Arrangements). While most of Paris was on vacation, 2 rue André Pascal was a hive of activity.

Branch mismatches occur where the residence and the branch (or PE) 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. The OECD is concerned that exploiting such mismatches may produce the same types of outcomes that are targeted in the BEPS Action 2 Final Report.

Mismatch types

This discussion document identifies five basic types mismatch arrangements that are specific to branches:

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

(b) the branch jurisdiction recognises the existence of the branch but a payment 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) 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) the same item of expenditure gives rise to a deduction under the laws of both the residence and branch jurisdictions; and

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

The consultation uses value-laden descriptions for the mismatches which imply contrived structures. Thus a “disregarded branch structure” exists where 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 a participation or foreign PE exemption) while the branch jurisdiction does not recognise the existence of the branch and therefore does not subject the payment to tax. Such outcomes have been possible where for example a Luxembourg company receives royalty payments which under Luxembourg law might be attributed to a United States permanent establishment, but under US law no branch or PE exists. These were the facts that formed the basis of the the EU Commission’s State Aid investigation into MacDonald’s (SA.38945 Alleged aid to Mc Donald’s – Luxembourg).See post by Werner Haslehner on June 22, 2016.

Other variations on this theme include the “diverted branch payment” where the payment is attributed to a different part of the enterprise by the laws of the state of residence and the state of the branch. The discussion draft proposes limiting the scope of the branch participation exemption to exclude payments that are not included in the tax base of the branch, in effect, a subject to tax rule. Alternatively, no deduction should be given for a payment that results in a mismatch giving rise to double non-taxation. In reality, no branch is “disregarded” in most cases – it simply does not exist under the tax laws of one state, even if it exists under the tax laws of the other. Similarly, the payments are not “diverted” from one part of the enterprise to another. Each state views attribution of the payment differently.

Consultation questions

Narrowly drafted questions for consultation do not fully address the fundamental questions about disparities between national tax systems. Which state should tax the item that benefits from double non-taxation? How do we distinguish between acceptable and unacceptable disparities? Instead, consultation questions only ask whether specific mismatch prevention rules should apply to payments made under a structured arrangement or between members of the same control group.

Ultimately, the OECD work will result in specific recommendations for improvements to domestic law intended to address these concerns. While some states may choose not to follow the recommendations, EU member states will need to pay attention. On 19 September 2016 the European Commission announced an in-depth state aid investigation into Luxembourg rulings on the tax treatment of zero interest convertible loans in the GDF Suez group (now Engie). These instruments gave rise to deductible interest expense for the borrower while the lender suffered no income inclusion on conversion of the loans to shares (Case number SA.44888; European Commission – Press release IP/16/3085). The Commission view this as inconsistent application of national law, giving rise to a discretionary double non-taxation in the same vein as the MacDonald’s ruling.

Welcome back to the Autumn work season.

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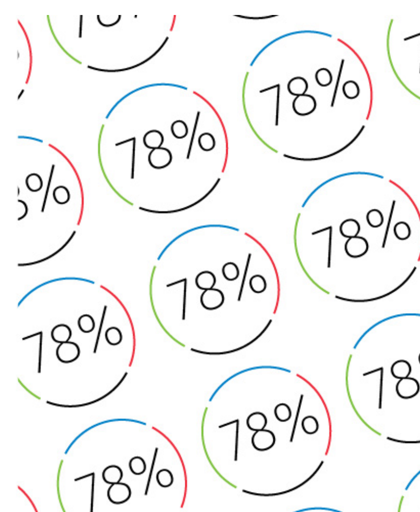

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