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NEUTRALISING THE EFFECTS OF BRANCH MISMATCH ARRANGEMENTS: A SOUTH AFRICAN PERSPECTIVE

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ABSTRACT

Base erosion and profit shifting (BEPS) has become an increasingly important matter for both multinational enterprises (MNEs) and the countries in which they operate. The tax avoidance strategies used to exploit gaps and mismatches in tax rules have become progressively complex and advanced over the past decade.

The aim of this research report is to determine the importance and relevance of addressing BEPS via branch mismatch arrangements, as proposed by the Organisation for Economic Co-operation and Development (OECD), to an emerging economy such as South Africa. The report discusses and analyses the concept of branch mismatch arrangements, the concerns and challenges arising from the use of these arrangements, the recommendations from the OECD in addressing these mismatches and the approaches taken by selected countries. Current domestic legislation is contrasted with international approaches and the recommendations by the OECD. The outcome of adoption or non-adoption of the recommendations will be investigated.

Keywords: Base erosion and profit shifting; BEPS; hybrid mismatch arrangements; branch mismatch arrangements; foreign branches; offshore branches; tax arbitrage; tax avoidance; income tax; double non-taxation.

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

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Table of Contents

Abbreviations and Acronyms

Abbreviation/Acronym	**Meaning**
BEPS	Base erosion and profit shifting
BRIC	Brazil, Russia, India and China
CFC	Controlled foreign company
COOP	Dutch Cooperative Associations
CTA	Corporate Tax Act [Selskabsskatteloven; Legislative Order No. 1164 of 6 September 2016]
D/NI outcome	Deduction / no inclusion schemes
DD outcome	Double deduction schemes
DTC	Davis Tax Committee
EEA	European Economic Area
EU	European Union
FA	The Finance Act 2016
FDI	Foreign direct investment

G20	Group of Twenty
GAAR	General anti-avoidance rule
HMRC	Her Majesty's Revenue and Customs
IT Act	Income Tax Act 58 of 1962
LLC	Limited liability company
MNE	Multinational Enterprise
NDP	National Development Policy
NTT	Danish National Tax Tribunal
OECD	Organisation for Economic Co-operation and Development
PE	Permanent establishment
SPV	Special Purpose Vehicle
TAA	Tax Assessment Act [Ligningsloven; Law No 1062 of 1 September 2016]
TIOPA	Taxation (International and Other Provisions) Act 2010

Chapter 1: Introduction

1.1 Introduction

Economic and technological advancements have changed the business landscape drastically over the past two decades. Businesses needed to adapt to these changes by implementing innovative business practices in order for them to stay competitive and continually grow in a rapidly developing environment. In response enterprises expanded their operations globally by creating multinational enterprises (MNEs). These MNEs are able to organise and allocate resources globally in order to maximise their profits. MNEs have become the main carriers of economic globalisation (Shangquan, 2000:2) and represent a large proportion of global gross domestic product (GDP) (OECD, 2013b:7).

Economic globalisation refers to the integration and interdependence of world economies as a result of the growing scale of cross border trade of goods and services, flow of international capital and the wide and rapid spread of technologies (Shangquan, 2000:1). The OECD Report on BEPS (2013b:7) notes that globalisation has had an important impact on the way cross border activities take place. Globalisation has boosted trade and increased foreign direct investments in many countries. It has also encouraged the free movement of capital and labour and resulted in the shift of manufacturing bases from high-cost to low-cost locations by MNEs in an attempt to minimise their tax burdens (OECD, 2013b:7). Jackson (2013) also notes that as globalisation has changed the way business is conducted it has also generated additional tax risks for organisations which had to be mitigated through clever tax planning.

In contrast to the rapid economic and technological advancements, tax laws, both domestic and international, have not advanced in line with the changes in global business practices. This provides opportunities for double non-taxation due to lacking coherence between countries and problems in enforcement by tax authorities (Lamers, Mcharo, & Nakajima, 2014:6). The term international tax law refers to the laws applied by a country to the taxing of an entity conducting business in two or more countries. This includes the domestic laws applicable to the taxation of non-residents, foreign income of residents and cross border transactions as well as double tax agreements.

Businesses integrate across borders, but tax rules often remain uncoordinated allowing the opportunity for technically legal structures which can take advantage of asymmetries in domestic and international tax rules (OECD, 2013a:7). MNEs have identified numerous planning opportunities to benefit from the gaps in the interaction of different tax systems as well as due to the application of bilateral tax treaties (OECD 2013b:10). Coherence between countries affected by a MNE's cross border activities only relates to possible double taxation and does not address possible non-taxation due to tax arbitrage.

The global economy requires countries to collaborate on tax matters to ensure proper interaction between tax systems in order to be able to protect their tax sovereignty (OECD, 2013b:9). From a government perspective, globalisation means that domestic policies, including tax policy, cannot be designed in isolation, that is without taking into account the effects on other countries' policies and the effects of other countries' policies on its own ones (OECD, 2013a:28).

On analysing Africa's Response to the OECD BEPS Action Plan, Oguttu (2016:12) states that:

> … it is clear that developing countries, such as those in Africa, have much more at stake in an effective international tax system because their development depends on it. This is confirmed by the 2015 IMF Spillovers Working Paper, which suggests that spillover effects on the tax base are substantially larger in developing than in advanced countries, which implies a likely loss of revenue from BEPS that is substantially larger for them. Spillover effects are essentially the impact of one country's tax policy on the tax bases of other countries (this could be either through investments or shifting of profits). Crivelli et al. 2015

Companies trading on a global scale have the opportunity to structure their operations in a manner that minimises their overall tax burden whilst still being highly profitable. This is mainly achieved by employing tax avoidance strategies which could lead to BEPS. BEPS is the erosion of a country's tax base due to the profits being artificially shifted to a low or no tax jurisdiction effectively separating the profits earned from the economic activity generating it (OECD 2013b:10). BEPS is a result of perceived weakness in international tax laws, as well as lack of administrative capacity to fully assess and audit international tax risks that are exploited by MNEs (Oguttu, 2016:15). The OECD conservatively estimates revenue losses from BEPS at between USD 100 billion and 240 billion annually. This is equivalent to between 4% and 10% of global revenues from corporate income tax (OECD, 2015b:1).

BEPS has received extensive media coverage over the last few years and concerns have been raised over the low taxes paid by large MNEs such as Google, Amazon and Starbucks (UK House of Lords Committee on Fiscal Affairs, 2014:21). The corporate tax affairs of these three US-based MNEs were initially placed under the spotlight by the United Kingdom Government, which initiated a global and public debate about how large MNEs are able to organise their tax affairs by exploiting BEPS opportunities (International Tax Review, 2013). The Organisation for Economic Co-operation and Development (OECD), in collaboration with the Group of Twenty (G20, 2012), developed an inclusive framework on BEPS in response to the need to address and prevent the activities that result in BEPS. The framework includes an action plan with 15 key focus points to address BEPS (OECD, 2013b).

South Africa is not a member of the OECD, but works closely with the OECD as an associate and is an active member of the Inclusive Framework for BEPS Implementation Steering Group (Steering Group) (OECD, 2018). South Africa is the only African member of the G20 (G20, 2018). The G20 is a leading forum of the world's major economies that seeks to develop global policies to address today's most pressing challenges. The work done by the OECD in addressing BEPS is thus of significance to South Africa as a member of the G20 and the Steering Group. As a result the Davis Tax Committee (DTC) was tasked by the Minister of Finance with addressing concerns about BEPS especially in the context of corporate income tax as identified by the OECD and the G20 (Davis Tax Committee, 2017b:8).

Action 2 of the BEPS Action Plan relates to Hybrid Mismatch Arrangements (OECD, 2013b:15). The first report addressing the tax and compliance issues relating to hybrid mismatch arrangements was issued in 2012 by the OECD. In 2015 the OECD published a report entitled 'Neutralising the Effects of Hybrid Mismatch Arrangements' setting out recommendations for domestic law as well as recommendations on treaty issues. The 2015 report only considered mismatches arising as a result of differences in the tax treatment or characterisation of an instrument or entity. Similar issues may arise through the use of branch structures owing to the inconsistencies in the domestic rules applicable to the determination of income and expenditure taxable in each jurisdiction (OECD, 2017:9). A report specifically aimed at neutralising the effects of branch mismatch arrangements was released by the OECD in 2017. The 2017 report entitled 'Neutralising the Effects of Branch Mismatch Arrangements' will be the focus of this research report.

The OECD defines hybrid mismatch arrangements as arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries (OECD, 2012:5). These arrangements appear to comply with the letter of the law of two countries, but still achieve non-taxation in both countries which may not have been the intention of either country (OECD, 2012:12). The OECD identified several tax policy issues arising from hybrid mismatch arrangements affecting amongst others tax revenue, competition, economic efficiency, transparency and fairness (OECD, 2012:11).

Branch mismatches differ from hybrid mismatches as these mismatches arise from differences in the rules of allocation of income and expenditure between jurisdictions whereas hybrid mismatches exploit the differences in tax treatment of instruments and entities. Branch mismatches also include situations where the branch jurisdiction does not treat the taxpayer as having a taxable presence in that country. Branch mismatches exploit both differences in the domestic rules for determining whether an enterprise is subject to tax in a particular jurisdiction and the amount of income and expenditure to be taken into account in calculating that tax liability (OECD, 2017:9). Branch mismatches thus exploit differences in tax accounting rather than focusing on legal characterisation (OECD, 2017:13). The OECD identified and discussed five basic types of branch mismatch arrangements in the 2017 report entitled 'Neutralising the Effects of Branch Mismatch Arrangements'. This report will be referred to as 'the branch report' in this research report. The branch report sets out specific recommendations for improvements to domestic law designed to reduce the frequency of branch mismatches. The report also sets out targeted branch mismatch rules, which neutralise the mismatch in tax outcomes without disturbing any of the other tax, commercial or regulatory outcomes (OECD, 2017:19).

In the 2013 OECD report entitled 'Addressing Base Erosion and Profit Shifting' the OECD states that 'tax policy is not only the expression of national sovereignty but it is at the core of this sovereignty, and each country is free to devise its tax system in the way it considers most appropriate' (OECD, 2013a:28). In this light the tax policy of South Africa is structured in such a way to best benefit the economic growth of the country by attempting to offer a competitive tax environment. South Africa's National Development Policy (NDP) requires that South Africa develops fiscal and economic policies that encourage foreign direct investment (FDI) to foster economic growth (Davis Tax Committee, 2017b:26). The Davis Tax Committee (2017b:26) discusses the need to develop a tax policy in line with the NDP to support its vision. This requires that tax policy should not prevent economic growth or adversely affect South Africa as a suitable foreign investor destination. Tax policy should foster an increase in tax revenues, an increase in the tax base and the creation of jobs in South Africa. They further conclude that measures adopted to counter BEPS should therefore not be counterproductive to the Constitutional and economic objectives of the government (Davis Tax Committee, 2017b:26). This indicates that a fine balance is needed between protecting South Africa's tax base and attaining the required economic growth.

BEPS takes advantage of a combination of features of tax systems which have been put in place by home and host countries. This implies that it may be very difficult for any single country, acting alone, to effectively combat BEPS behaviours (OECD, 2013a:45). It is thus imperative that there is some cohesion between countries to protect their tax bases whilst still attaining tax sovereignty and aligning tax policies with the country's economic policy.

South Africa has enacted some legislation in an attempt to neutralise hybrid mismatch arrangements. Hybrid entities are taxed in terms of the 'foreign partnership' definition in section 1 of the Income Tax Act 58 of 1962 (IT Act) read with section 24H of the IT Act. Hybrid instruments are addressed in sections 8E-8FA, 10(1)(k), 10B, 23M, 23N and 24J of the IT Act. There are no specific provisions aimed at the taxation of local branches or neutralising the effect of branch mismatch arrangements in South Africa and the general provisions contained in the IT Act are thus applied. In relation to foreign branches section 6quat of the IT Act provides for the deduction of a tax credit based on the tax paid to a foreign government, subject to certain limitations. The lack of legislation addressing branch mismatch arrangements indicates that South Africa may indeed be vulnerable to tax arbitrage through these types of arrangements.

The following aspects will be covered in the research report:

A brief overview of the elements of a hybrid mismatch arrangement and the effects of these arrangements on the parties involved and their tax liability will be performed. Policy issues and possible policy options as set out by the OECD will be discussed.

Branch mismatch arrangements will be defined and a discussion on the basic types of branch mismatches will follow. The outcomes of the identified types of branch mismatch arrangements will be examined to determine the effect of the arrangements on the tax base of the countries involved. This will be performed with reference to the 2017 OECD report entitled 'Neutralising the Effects of Branch Mismatch Arrangements'.

The research report will then proceed to discuss and examine the recommendations as proposed by the OECD to neutralise the identified effects of branch mismatch arrangements as set out in the 2017 OECD branch report.

The United Kingdom, New Zealand and Australia are the only countries who have already implemented changes in their domestic law to adopt the recommendations as set out in the 2015 OECD report addressing hybrid mismatch arrangements and to a lesser degree the recommendations set out in the branch report. This research report will examine the approaches taken by these countries in adopting the recommendations as well as the challenges experienced. The abovementioned countries were selected for review Countries such as the United States of America and Luxembourg are currently preparing proposed draft legislation relating to the implementation of the recommendations to address hybrid mismatch arrangements. It is not feasible to include a study of the draft legislation of these countries in this research report. The review of legislation implemented by other countries will therefore be limited to the United Kingdom, New Zealand and Australia as they are the frontrunners in the BEPS Action 2 arena and have already included the recommendations in their domestic legislation. Furthermore, New Zealand and Australia has a similar tax regime to South Africa which allows for comparison.

An overview of current South African legislation in relation to the taxation of branches will be performed and contrasted against the recommendations by the OECD branch report and the law enacted by other countries where the recommendations have already been adopted. The research report will investigate the effect on the South African tax base should South Africa choose not to adopt the recommendations versus the effect of adopting the recommendations. The results will be examined for situations where transactions occur with both adopting and non-adopting countries and will identify possible changes in law that can be adopted in South Africa to respond to the risks identified without losing sight of the economic goals as set out in the NDP.

1.2 The Research Problem

1.2.1 Statement of the problem

During the past few years significant progress has been made by the OECD in identifying possible hybrid mismatch arrangements used by multinational companies to achieve double non-taxation (OECD, 2015a:11). The OECD developed recommendations for rules to address mismatches in tax outcomes arising from the use of hybrid entities and hybrid financial instruments with the aim to neutralise the effect of these arrangements (OECD, 2015a:11). In 2017 the OECD released a report specifically aimed at branch mismatch arrangements and recommendations to neutralise the effect these types of arrangements. This research report aims to determine the importance and relevance of addressing tax arbitrage via branch mismatch arrangements, as proposed by the OECD, to an emerging economy such as South Africa.

1.2.2 The Sub-Problems

a) The first sub-problem is to analyse the concept of hybrid mismatch arrangements.
b) The second sub-problem is to determine the issues giving rise to branch mismatch arrangements and the importance of neutralising the effects of these arrangements.
c) The third sub-problem will unpack the recommendations issued by the OECD in addressing the mismatches arising from branch mismatch arrangements.
d) The fourth sub-problem examines the methodologies used, in the adoption of the OECD recommendations in relation to branch mismatches, by selected countries such as the United Kingdom, Australia and New Zealand.
e) The fifth sub-problem is to compare the current domestic legislation addressing branches and hybrid mismatch arrangements to the recommendations issued by the OECD and as adopted by the selected countries. The effects of adopting versus non-adopting of the recommendations by South Africa will be investigated. Possible changes in law that can be adopted in South Africa to respond to the risks identified will be examined.

1.3 Research Methodology

The research was conducted through an extensive literature review using a qualitative approach. The resources utilised were current income tax legislation, journal articles, dissertations, publications by international and government organisations and conference proceedings and presentations.

1.4 Scope and Limitations

1.4.1 Goal of the research

The aim of this research report is to determine the importance and relevance of addressing BEPS via branch mismatch arrangements, as proposed by the Organisation for Economic Co-operation and Development (OECD), to an emerging economy such as South Africa. The OECD has noted that 'Africa is the new emerging markets investment frontier' (Oguttu, 2016:18). South Africa is thus in a unique position when determining the relevancy of BEPS exposure and whether addressing branch mismatch arrangements will be to the benefit or detriment of the country.

Previous research has been conducted on hybrid entities from a South African perspective by Tlale (2014) as well as from an international perspective by Floren (2014). Research has also been conducted on hybrid instruments in a South African context by McCann (2015) based on the 2015 OECD report entitled 'Neutralising the Effects of Hybrid Mismatch Arrangements'. Tlale (2014) mainly focused on foreign partnerships and how the classification and taxation of offshore hybrid entities from a South African tax perspective compares to international approaches. Floren (2014) focused on tax structures involving hybrid entities, the US and Canada treaty, the concept of residence and how the OECD approach to neutralising hybrid mismatch arrangements affects these issues. McCann (2015) assessed the potential implication of the recommendations discussed in the abovementioned report on South African tax laws and double tax conventions in relation to cross border financing arrangements using hybrid financial instruments.

Research on the broader theme of BEPS has also been conducted and specifically on BEPS exposure for South Africa (Bob, 2014) and curbing offshore tax avoidance relating to South African companies and trusts (Oguttu, 2007).

The Davis Tax Committee, in its second and final report on BEPS for the Minister of Finance, limited their response on Action 2 of the BEPS Action Plan to the issue of neutralising the tax benefits of hybrid mismatch arrangements (Davis Tax Committee, 2017c:1).

A study was conducted during which a comparative analysis was performed between four developing countries, Uruguay, Colombia, Brazil, and South Africa, to determine whether addressing tax arbitrage via hybrid mismatches as proposed by the OECD is of interest and relevance for developing countries (Kuzniacki et al, 2017:1). The study was conducted by addressing questionnaires to possible relevant stakeholders. The study did not incorporate branch mismatch arrangements and did not take into the account the unique situation of South Africa as an emerging economy and a gateway of investment into the rest of Africa.

Research specifically aimed at branch mismatch arrangements and the recommendations as set out in the 2017 OECD report entitled ‘Neutralising the Effects of Branch Mismatch Arrangements’ does not appear to have been done either from an international or a South African perspective. South Africa is in the distinct position where its economy portrays aspects of both a developed and developing economy (Davis Tax Committee, 2017a:5). In many respects South Africa is considered a source country by the Davis Tax Committee (2017a:6) as the country largely attracts and relies heavily on foreign direct investment (FDI). Income generated from FDI may only be taxed if it originates from a South African source and may be subject to tax treaties. South Africa is also the residence state of many home grown MNEs, and it is a base country to many intermediate MNEs for further investment into the rest of Africa. As a residence country Action 2 of the 2017 OECD report on branch mismatch arrangements contain proposals that may have serious implications for South Africa that is home to multinational groups (Davis Tax Committee, 2017a:6). It is therefore important to determine the possible implications the adoption of these recommendations by contracting states will have on South Africa’s tax base should South Africa choose not adopt the recommendations. It is also necessary to examine whether the adoption of the recommendations by South Africa will appropriately address tax arbitrage occurring via branch mismatch arrangements.

1.4.2 Limitation of scope

A branch operating in a foreign country may give rise to a permanent establishment (PE) in terms of the domestic law of that country or owing to the application of a double tax treaty. For the purposes of this research report it will be assumed that all branches discussed and referred to have resulted in the creation of a PE in either South Africa or the stated foreign country depending on the example that will be used for explanatory and comparative purposes of possible mismatch arrangements. The concept of PE will not be expanded or discussed for the purposes of this research report. The interaction with and application of tax treaties will also not be addressed or considered in this research report. These concepts are dealt with extensively in the reports on Action 6: Treaty Abuse and Action 7: Permanent Establishment Status of the BEPS Action Plan and fall outside the ambit of this research report.

Transfer pricing provisions are applicable when related entities in different tax jurisdictions transfer goods and services amongst each other. Transactions between a branch and their head office should be concluded at arm’s length in terms of section 31 of the IT Act. A detailed discussion on transfer pricing principles and the application thereof will not form part of the research report.

It is normal business practice for a head office to provide financing to its branches via the provision of cross border financing arrangements. The issues relating to the deductibility of the interest paid by the branch and associated matters resulting from hybrid financial instruments will not form part of this research report as sufficient research has been conducted by McCann (2015) on hybrid financial instruments as indicated under goal of the research.

1.5 Chapter Outline

1.5.1 Chapter 1 – Introduction

The first chapter will commence with an introduction to the proposed topic and a discussion of the background of the research performed. A general discussion of BEPS, the related issues and current landscape will follow. The introductory chapter will include the significance of the research, limitation of scope, research methodology applied, the research problem and the related sub-problems.

1.5.2 Chapter 2 – Hybrid mismatch arrangements

This chapter will discuss and analyse the concept of hybrid mismatch arrangements. The elements and effects of hybrid mismatch arrangements will be considered. The concerns and challenges arising from the use of these arrangements will also be examined. The chapter will include an evaluation of legislation previously enacted by selected countries such as the United Kingdom and Denmark to address hybrid mismatch arrangements.

1.5.3 Chapter 3 – Branch mismatch arrangements

This chapter will discuss and define branch mismatch arrangements, the circumstances giving rise to the mismatches will be analysed and the issues arising from the use of these arrangements will be investigated. The basic types of branch mismatches will be identified and the outcomes of each type of branch mismatch will be evaluated. Examples of possible mismatch arrangements will be analysed to determine the impact of these arrangements on a country's tax base. The challenges experienced by tax authorities in relation to these arrangements will also be discussed in this chapter.

1.5.4 Chapter 4 – Recommendations by the OECD to neutralise the effect of branch mismatch arrangements

This chapter will focus on the recommendations as set out in the 2017 OECD report entitled 'Neutralising the Effects of Branch Mismatch Arrangements'. The recommendation linked to each category of branch mismatch will be unpacked and the intended outcome will be analysed. The primary and secondary/defensive rules pertaining to each recommendation and the scope thereof will be examined. The impact of the recommendations on both adopting and non-adopting countries will be evaluated per category of mismatch. The concerns in relation to the adoption of the recommendations by the OECD will also be discussed in this chapter.

1.5.5 Chapter 5 – Response of selected countries to the OECD recommendations

The views on the adoption of BEPS and specifically the recommendations set out by the OECD on neutralising the effects of hybrid mismatch arrangements will be investigated. The available options in adopting the OECD recommendations will be investigated. This chapter will examine the approaches taken by selected countries including the United Kingdom, New Zealand and Australia in adopting the recommendations by the OECD in relation to hybrid mismatch arrangements as well as branch mismatch arrangements where applicable. The issues considered and the amendments made to domestic law in this regard will be examined. The amendments made to their domestic legislation will be examined and discussed. The challenges experienced by the adopting countries will also be taken into consideration.

1.5.6 Chapter 6 – Taxation of branch mismatch arrangements from a South African perspective

This chapter will commence with a discussion on the current domestic legislation applicable to the taxing of local branches of foreign MNE's as well as the legislation applicable to the taxing of a resident MNE's offshore branch. A comparative analysis between the current South African legislation available to address branch mismatch arrangements and the recommendations issued by the OECD will be performed.

The outcome of a study performed by Kuzniacki et al (2017) on the effect of tax arbitrage via hybrid mismatches on developing companies such as Columbia, Uruguay, South Africa and Brazil will be analysed. This will be contrasted against the approaches taken by the selected countries who have already implemented the hybrid mismatch recommendations, which includes the United Kingdom, New Zealand and Australia, to identify the determining factors that will influence the decision of whether or not to adopt the recommendations.

An evaluation will be performed on the types of issues to be considered when planning to adopt the recommendations as set out by the OECD.

The chapter will include a detailed discussion on the options available to address the mismatches.

1.5.7 Chapter 7– Conclusion

This chapter will summarise the findings of the research based on the previous chapters. The collated findings will be assessed against the problem statement with concluding remarks and the possible recommendations applicable to South Africa based on the research performed will follow.

Chapter 2 – Hybrid mismatch arrangements

2.1 Introduction

Branch mismatch arrangements falls within Action 2 of the OECD BEPS action plan dealing with neutralising the tax benefits arising from the use of hybrid mismatch arrangements. Understanding the concept of hybrid mismatch arrangements is thus an important starting point in the study of branch mismatch arrangements.

This chapter will focus on hybrid mismatch arrangements as an introduction to the concept of branch mismatch arrangements.

This chapter will define the following key concepts:

- Hybrid mismatch arrangements
- Hybrid entities

The underlying elements found in hybrid mismatch arrangements will be discussed in this chapter. The effects of these arrangements and the results they aim at achieving will be examined and discussed.

This chapter will look at the tax policy issues that arise from the use of hybrid mismatch arrangements. The possible policy options, as identified by the OECD in the 2012 OECD report entitled 'Hybrid Mismatch Arrangements: Tax and Compliance Issues', which can be implemented to address the hybrid mismatch arrangements, will also be discussed.

An evaluation will be performed on the legislation and /or rules that have previously been introduced by a number of countries in an attempt to address the risk of hybrid mismatch arrangements. The selected countries that will be analysed are the United Kingdom and Denmark.

2.2 Key terms defined

2.2.1 Hybrid mismatch arrangements

In the 2015 OECD report entitled 'Neutralising the Effects of Hybrid Mismatch Arrangements' the OECD defines hybrid mismatch arrangements as arrangements that 'exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation including long-term deferral' (OECD, 2015:11).

The 'hybrid' part of the phrase means that, in a particular case (taken to be an 'arrangement'), two countries do not agree on the classification or characterisation of some feature of the arrangement that is fundamental for income tax purposes. The 'mismatch' feature is different and suggests that the different ways in which two countries view the particular arrangement produce some sort of inconsistent outcome when looked at in the whole. (Harris, 2014:3)

A hybrid mismatch arrangement is effectively a profit shifting arrangement that generates a mismatch in tax outcomes in respect of a payment made in terms of that arrangement resulting in a lower aggregate tax obligation for the contracting parties (Brunton, 2016:4).

2.2.2 Hybrid entities

A "hybrid entity" refers to a legal relationship that is treated as a corporation in one jurisdiction and as a transparent (non-taxable) entity in another (Davis Tax Committee, 2017c:9).

The hybridity of an entity is generally a function of its transparency or opacity for tax purposes; and consequently how its tax treatment in a particular jurisdiction impacts a particular payment. Since hybrid entities are treated as tax transparent in one jurisdiction and non-transparent or opaque in another hybrid mismatch arrangements exploit the transparency or opacity of the entity for tax purposes to the extent that the discrepant tax treatment of the hybrid entity as between jurisdictions impacts a particular payment. (Davis Tax Committee, 2017c:10)

A branch and a hybrid entity are similar to the extent that a branch is transparent in the head office jurisdiction, but can be either opaque or transparent in the branch jurisdiction depending on their PE status. Yet, there are vast differences between a branch and a hybrid entity such as a partnership. These differences between a branch and a hybrid entity required the OECD to design a specific set of rules catering to the specific nature of branches. This translated into the branch report.

2.3 Elements of hybrid mismatch arrangements

In the 2012 OECD report entitled 'Hybrid Mismatch Arrangements: Tax and Compliance Issues' the OECD identified that one or more of the following underlying elements are generally present in hybrid mismatch arrangements (OECD, 2012:7):

2.3.1 Hybrid entities

Hybrid entities are treated as transparent for tax purposes in one country and as non-transparent (opaque) in another country (OECD, 2012:7).

The differing tax treatment of the entity in the two countries (residence and source country) creates many tax planning opportunities to reduce the overall tax liability of the contracting parties (Davis Tax Committee, 2017c:10).

In the South African context partnerships, both local and foreign, are treated as transparent entities as the tax liability of the partnership ultimately rests with the partners in terms of section 24H of the IT Act. South Africa taxes residents on their worldwide income. Non-residents are taxed on income received by or accrued to or in favour of such person from a source within the Republic in terms of section 1(1) word definition 'gross income'.

In the event that a foreign partner resident in Country 1 is conducting business through a partnership situated in South Africa (Country 2) a portion of the partnership's income can be taxed in the hands of the foreign partner by South Africa in terms of section 24H of the IT Act read with the definition of 'gross income' contained in section 1(1) of that Act. Should the partnership be situated in South Africa, but all income earned by the partnership is earned from a source outside South Africa (in Country 3), the non-resident partner cannot be taxed from a South African perspective as there is no income from source within South Africa. As the partnership is situated in South Africa there is no PE created in the source country (Country 3) and unless treaty provisions provides for withholding tax on income the source country cannot tax the partnership. Should the non-resident partner's country of residence (Country 1) deem the South African partnership to be a separate taxable entity there will also be no tax payable in the residence country of the non-resident partner. The non-resident partner will thus avoid paying tax in all three countries.

The 'limited liability company' (LLC) in the United States of America is seen as a hybrid form of business organisation as it has some attributes of a partnership and other attributes of a corporation resulting in it being recognised as a corporate entity in the United States, but treated as a partnership for tax purposes (Oguttu, 2009:67). A LLC is thus a hybrid entity based on its inherent nature.

Dutch Cooperative Associations (COOP) are also hybrid entities based on its inherent nature. The COOP has a legal personality but it does not have shares and instead of shareholders it has members (Brunton, 2016:4). The COOP is treated as a taxable entity for Dutch corporate tax purposes. Owing to the fact that the COOP has no shareholders and that the members can assume restricted liability or even full liability the COOP may fall within the definition of a limited liability partnership in terms of the domestic laws of some countries (Peters, 2012).

2.3.2 Dual residence entities

Dual residence entities are resident in two different countries for tax purposes (OECD, 2012:7). These entities obtain dual residency as they are resident in the country of incorporation and they achieve tax residency in the country of effective management. This may sometimes result in double deductions. An example of a scheme that was used to avoid taxes in this regard is the Double Irish and Dutch Sandwich scheme used by Google (Davis Tax Committee, 2017c:12). In this scheme a company incorporated in Ireland collects most of the company's international revenue and then transfers the money on to a Dutch subsidiary. The Dutch company then transfers the money on to an Ireland holding company which is based in a tax haven such as Bermuda. The use of the two Irish entities is what gives the structure its 'Double Irish' moniker and the use of the Netherlands subsidiary as a conduit between the two Irish companies is the 'Dutch Sandwich' (Kahn, 2018).

The Irish Government has since closed the tax loophole that permitted 'Double Irish' tax arrangements by amending their tax legislation in 2015. All companies incorporated on or after 1 January 2015 will be classified as tax-residents of Ireland and cannot benefit from this current loophole (Stein, 2015). Companies already using the structure are allowed to continue employing it until the end of 2020 (Kahn, 2018).

2.3.3 Hybrid instruments

Hybrid instruments arise when the tax treatment of a financial instrument differs in the countries involved, most prominently when the instrument is treated as debt in one country and as equity in another country (OECD, 2012:7).

A hybrid financial instrument may be described as a financial instrument which possesses economic characteristics which are partially or wholly inconsistent with the classification of its legal form (Davis Tax Committee, 2017c:19). Tax arbitrage through the use of hybrid financial instruments and the impact of the OECD recommendations thereon was studied by McCann (2015).

2.3.4 Hybrid transfers

Hybrid transfers are arrangements that are treated as transfer of ownership of an asset for one country's tax purposes but not for tax purposes of another country, which generally sees a collateralised loan (OECD, 2012:7).

Hybrid transfers are typically a particular type of collateralised loan arrangement or derivative transaction in terms of which both parties to the same arrangement in different jurisdictions consider themselves to be the owner of the loan collateral or subject matter of the derivative (OECD, 2014:34).

Hybrid transfers are seen as a type of hybrid instrument (Davis Tax Committee, 2017c:22).

2.4 Effects of hybrid mismatch arrangements

Hybrid mismatch arrangements can have different tax outcomes based on the nature of the arrangement and the type of scheme employed.

The results hybrid mismatch arrangements aim at achieving generally fall within one of the following categories (OECD, 2012:7):

2.4.1 Double deduction schemes (DD outcome)

Double deduction schemes involve arrangements where a deduction related to the same contractual obligation is claimed for income tax purposes in two different countries (OECD, 2012:7).

Double deductions can arise when the expenditure is required to be taken into account in calculating the taxpayer's net income under the laws of two or more jurisdictions; or in the case of a payment made by a hybrid person that is treated as transparent by one of its investors, the payment is also treated as deductible in calculating the net income of that investor (OECD, 2015:68).

2.4.2 Deduction / no inclusion schemes (D/NI outcome)

Deduction/No inclusion schemes are arrangements that create a deduction in one country, typically a deduction for interest expenses, but avoid a corresponding inclusion in the taxable income in another country (OECD, 2012:7).

This generally occurs through the use of a hybrid entity or a hybrid loan (OECD, 2012:9). When a hybrid entity makes a payment to its shareholders the payment is deductible in the so-called payer jurisdiction where it is recognised as a separate entity, but the income is disregarded in the country of residence of the shareholder which treats the entity as transparent and therefore sees the entity effectively paying itself. In term of a hybrid loan the interest on the hybrid loan is treated as taxable income/deductible expenditure in the so-called payer jurisdiction, but is treated as exempt dividends in the country of residence of the ultimate parent company. The group is able to obtain an interest deduction by the operating subsidiary with no corresponding income being declared in the country of residence of the ultimate parent company.

2.4.3 Foreign tax credit generators

Hybrid mismatch arrangements generate foreign tax credits that arguably would otherwise not be available, at least not to the same extent, or not without more corresponding taxable foreign income being recognised (OECD, 2012:7). The main purpose of a tax credit is to eliminate any potential double taxation in instances where, for example, both countries have a taxing right to the branch's taxable income (PKF, 2016).

One of the typical schemes identified by the OECD employed to generate a foreign tax credit uses a hybrid transfer of an equity instrument, generally a sale and repurchase agreement concerning shares, through a Special Purpose Vehicle (SPV). The transaction is treated as a sale and a repurchase of the shares in one country, while in the other country it is treated as a loan with the shares serving as collateral. One or more of the countries have an indirect foreign tax credit regime, allowing them to claim a tax credit for the corporate income tax paid by the SPV. (OECD, 2012:10)

The role of a foreign tax credit is as an allocator of the international tax base between residence and source countries and should not result in reducing the overall tax liability of the entity or group of entities (Fleming, Peroni & Shay, 2016:2).

Fleming, Peroni and Shay (2016:11) explains their reasoning as follows:

> The economic standard of capital export neutrality holds that a business or investment activity should bear the same income tax burden regardless of whether the activity takes place in the taxpayer's residence country or in a foreign country. The standard's underlying rationale is that its application makes income taxation a neutral factor in deciding where to locate business or investment activity so that the decision is based on a comparison of economic merits, thereby contributing to greater worldwide efficiency and economic growth than would be the case if tax considerations drove the choice of location.

It is therefore clear that the purpose of a foreign tax credit is to neutralise the effect of taxation on businesses located offshore and not to achieve a tax saving for the group.

2.5 Tax policy issues and options

2.5.1 Tax policy issues arising from the use of hybrid mismatch arrangements

Hybrid mismatch arrangements raise a number of tax policy issues, affecting amongst others tax revenue, competition, economic efficiency, transparency and fairness (OECD, 2012:11).

The use of these arrangements typically leads to a reduction of the overall tax paid by all parties involved as a whole. It is often difficult to determine which of the countries involved has lost tax revenue, but it is clear that collectively the countries concerned lose tax revenue (OECD, 2012:11). The difficulty encountered with these types of arrangements is the fact that they are compliant with the letter of the law in both of the affected tax jurisdictions, yet they achieve a result unintended by either jurisdiction. The tax policy concern is that income from these cross-border transactions may escape tax altogether, or alternatively be taxed at unduly low rates either due to the lacuna between the different tax systems of the countries involved, or the application of certain bilateral tax treaties (Davis Tax Committee, 2017c:24).

Hybrid mismatch arrangements affect competition as it creates unintended competitive advantages for companies operating cross-border compared with other businesses, such as small and medium-sized enterprises, that cannot or cannot easily use mismatch opportunities (OECD, 2012:11).

Hybrid mismatch arrangements also affect economic efficiency. Where a hybrid mismatch is available a cross-border investment will often be more attractive than an equivalent domestic investment in the investor's country (thus affecting Capital Export Neutrality) as well as more attractive than a competing local investor's investment in the target country (thus affecting Capital Import Neutrality) (OECD, 2012:11).

Weisbach (2014:3) explains the concept of capital export neutrality and capital import neutrality as follows:

> Capital export neutrality (CEN) requires residents of any given nation to face the same tax burden no matter where they choose to invest. CEN tries to identify conditions under which investment is allocated efficiently. Capital import neutrality (CIN), by contrast, is about savings. It requires that all investments in a given country pay the same marginal rate of tax regardless of the residence of the investor.

Transparency is also affected by hybrid mismatch arrangements. The public will be generally unaware that there is a different effective tax regime for those taxpayers that can profit from mismatch opportunities (OECD, 2012:11).

Another policy issue arising from the use of these arrangements is fairness. Mismatch opportunities are available only to a select group of taxpayers who have the ability to reduce their taxes. This may affect public confidence in the fairness of the tax system. (OECD, 2012:11).

2.5.2 Tax policy options to address hybrid mismatch arrangements

In the 2012 OECD report entitled 'Hybrid Mismatch Arrangements: Tax and Compliance Issues' the OECD discussed several domestic law options for countries concerned with hybrid mismatch arrangements (OECD, 2012:13):

2.5.2.1 General anti-avoidance rules

General anti-avoidance rules could be an effective tool in addressing some hybrid mismatch arrangements, particularly those with circular flows, contrivance or other artificial features. The terms of general anti-avoidance rules and the frequent need to show a direct link between the transactions and the avoidance of that particular jurisdiction's tax tended to make the application of general anti-avoidance rules difficult in many cases involving hybrid mismatch arrangements (OECD, 2012:13).

This policy option will not have the desired effect owing to the possible limitations in application and would thus be considered only if the country has limited exposure to hybrid mismatch arrangements and the arrangements that do occur will fall within the provisions requiring contrivance.

2.5.2.2 Specific anti-avoidance rules

Countries such as the Netherlands, Austria, the United Kingdom and Sweden have introduced specific anti-avoidance rules which may directly or indirectly impact on hybrid mismatch arrangements (OECD, 2012:13). The provisions introduced by these countries are not specifically aimed at deductions with no corresponding inclusion for tax purposes, but they may impact on those types of structures by denying the deduction at the level of the payer (Davis Tax Committee, 2017c:26).

This policy option also has limitations as it will only apply to a small number of transactions and it is possible for taxpayers to structure a transaction in order for it to specifically fall outside the scope of the provisions enacted.

2.5.2.3 Rules specifically addressing hybrid mismatch arrangements

A number of countries have introduced rules which specifically address certain hybrid mismatch arrangements (OECD, 2012:13). Under these rules the domestic tax treatment of an entity, instrument or transfer involving a foreign country is linked to the tax treatment in that foreign country, thus eliminating the possibility for mismatches (Davis Tax Committee, 2017c:26). These rules will be further examined under point 2.6.

2.6 Rules specifically addressing hybrid mismatch arrangements implemented by selected countries

2.6.1 Rules addressing the multiple deduction of the same expense

Countries such Denmark and the United Kingdom have implemented rules in their domestic legislation in an attempt to avoid double deductions obtained through the use of hybrid mismatch arrangements (OECD, 2012:15).

Denmark

In terms of section 5G of the Tax Assessment Act (TAA) [Ligningsloven; Law No 1062 of 1 September 2016] a Danish resident taxpayer is not entitled to claim a deduction for an expense if (i) that expense is claimable under foreign tax rules against income that is not included in the computation of Danish tax, or (ii) if under the foreign tax rules, the expense is deductible against income derived by affiliated companies which is not included in the computation of Danish tax (OECD, 2012:15). The provisions are referred to as dual consolidated loss rules. These dual consolidated loss rules disallow a deduction for expenses in Denmark if the expenses are also deductible in a foreign country, colloquially termed a “double dip” (Davis Tax Committee, 2017c:49).

Similar rules exist in the case of PEs. In terms of section 31.2 of the Corporate Tax Act (CTA) [Selskabsskatteloven; Legislative Order No. 1164 of 6 September 2016] losses of a PE cannot be set off against other group members’ profits if the loss is included in the company’s income in the country of residence. The losses can only be carried forward against future profits of the PE (OECD, 2012:15).

United Kingdom

The United Kingdom (UK) previously enacted targeted legislation against double deductions as per section 244 of the Taxation (International and Other Provisions) Act 2010 (TIOPA) that applied where there were two deductions for tax purposes in relation to the same expense (OECD, 2012:16).

The Finance Act 2016 (FA) has since been enacted with a commencement date of 1 January 2017. Schedule 10 of the FA deleted the double deduction provisions contained in section 244 of the TIOPA and inserted part 6A of the TIOPA dealing with hybrid and other mismatches. Sections 259I - 259IC in chapter 9 of part 6A to the TIOPA contains legislation aimed at hybrid entity double deduction mismatches. Sections 259J - 259JD in chapter 9 of part 6A to the TIOPA contains legislation aimed at dual territory double deduction cases. The newly enacted legislation closely follows the recommendations made by the OECD in the 2015 report entitled ‘Neutralising the Effects of Hybrid Mismatch Arrangements’.

The amendments are discussed in more detail in chapter 5.6.1.

2.6.2 Rules addressing the deduction of payments which are not included in the taxable income of the recipient

Denmark and the United Kingdom have rules which in certain cases deny the deductibility of payments that are not taxable at the level of the recipient due to a mismatch in treatment (OECD, 2012:17).

Denmark

Section 2A of the CTA deems a Danish company or a foreign company with a PE in Denmark as transparent for all purposes of Danish tax law if:

(i) the company is disregarded for tax purposes in a foreign country,

(ii) the income of the company is included in the foreign taxable income of one or more affiliated companies in the foreign country that disregards the company;

(iii) the foreign affiliated companies control the company, and

(iv) the foreign jurisdiction is an European Union EU or European Economic Area EEA state, or has concluded a tax treaty with Denmark.

In these circumstances the company will not be entitled to a deduction for payments made to the foreign parent company since the payments are considered to be within the same legal entity (OECD, 2012:17).

Sometimes rules implemented with the purpose of protecting the country's tax base can have the opposite effect and unintended consequences may arise. A prime example of this can be found in the administrative ruling made the by Danish National Tax Tribunal (NTT) case 09-0219174, SKM2013.234.LSR on 30 January 2013. Through the use of the United States check-the-box regulations and by invoking the Denmark-US tax treaty the Danish private limited company (anpartsselskab) and the American parent company escaped paying Danish tax that would have, in the absence of section 2A of the CTA, been payable. The anti-hybrid rules implemented by Denmark to prevent D/NI outcomes effectively prevented the Danish Tax Authority from taxing the income of a Danish subsidiary. (Wittendorf, 2013)

Section 2C of the CTA deals with cases of deduction/no inclusion through entities which are treated as fiscally transparent for Danish tax purposes but as separate taxable entities for foreign tax purposes. The legislation applies to partnerships organised in Denmark, Danish registered branches of foreign entities and tax transparent entities that are organised in Denmark, have their registered seat in Denmark, or have their effective seat of management in Denmark where:

(i) more than 50% (votes or capital interests) of the direct partners/owners are residents in foreign states, and

(ii) those states consider the entity to be a separate taxable entity or do not have a tax treaty with Denmark.

In these circumstances the entity will be subject to the same tax treatment as Danish resident companies. Distributions from these entities will be treated as a dividend distribution for tax purposes and consequently could be subject to withholding tax (OECD, 2012:18).

2.7 Conclusion

Hybrid mismatch arrangements can be structured in many ways depending on the domestic laws of the specific countries involved and the tax treaties that may be applicable. It may therefore be extremely difficult for revenue authorities to identify whether a hybrid mismatch has occurred without having some insight into the specifics of the arrangement and lacking a proper understanding of the domestic law policies of all the countries involved.

Branch mismatch arrangements has the same tax policy concerns and outcome as hybrid mismatch arrangements, but owing to the differences in how the mismatches arise a separate set of rules are required to address branch mismatch arrangements.

There is undeniably a significant benefit that can be obtained by MNEs through the use of hybrid mismatch arrangements. As can be seen from the Double Irish and Dutch Sandwich scheme used by Google clever tax planning can result in extremely profitable companies paying little to no tax. This may encourage MNEs to engage in aggressive tax planning in order to avoid tax.

Countries such as Denmark and the United Kingdom view the threat to their tax base from hybrid mismatch arrangements as significant and have implemented domestic rules to specifically address tax arbitrage arising through the use of these schemes. As proven by the Danish NTT case discussed above sometimes unintended consequences can arise and the specific rules enacted do not operate as envisaged.

Developing countries may not be fully aware of the impact that hybrid mismatch arrangements may have on their tax base and has not made any attempt to counteract the practice.

Boidman and Kandev (2014) are of the opinion that planning opportunities are created by the willingness of source countries to allow for example a measure of deductible interest on internal financing:

> Whether source countries do so is a matter of tax policy not different from the question whether corporate tax rates should be higher or lower. Simply put: Once a source country decides that a certain amount reduces (or as the OECD would prefer, erodes) its tax base, whether the amount is taxable elsewhere is unimportant. (Boidman & Kandev, 2014:1243)

Boidman and Kandev (2014) also state that:

> Against this background, it is plain that income that, through tax planning (whether or not it involves hybrids), is deductible at source without resulting in a corresponding inclusion anywhere else is not stateless income that has slipped through a loophole in the system, but rather is the result of conscious tax policy choices by the countries involved. In fact, a country's

> accepting such planning techniques is merely a form of economic subsidy to cross-border investment flows. (Boidman& Kandev, 2014:1244)

It would appear that some do not see hybrid mismatch arrangements as tax avoidance strategies that have to be neutralised, but rather as an acceptable consequence of a country's expression of national and tax sovereignty.

Boidman and Kandev (2014:1244) notes that many of the hybrid mismatch arrangements trace their origins to the United States, a country which is a typical example of a residence/capital exporting state. There is little motivation for the United States to support the OECD's anti-hybrid rules, especially in light of their pro-source-country bias, because they would ultimately negatively affect United States' resident MNEs. It is thus doubtful that the United States will participate in Action plan 2 of the OECD.

Dachs (2014) is of the opinion that from a South African tax perspective transactions that involve hybrid entities or instruments may result in the claiming of foreign tax credits in circumstances where the foreign tax suffered is effectively neutralised in the foreign jurisdiction. This could indicate the relevance of addressing tax arbitrage through hybrid mismatch arrangements for South Africa.

It is therefore important for each country to review whether hybrid mismatch arrangements pose a threat to their tax base or whether the outcome is as a result of conscious tax policy choices by the country. The country should also evaluate what the impact on resident MNEs and cross-border investments would be if legislation is enacted to address these mismatches.

Chapter 3 – Branch mismatch arrangements

3.1 Introduction

This chapter will discuss and define the concept of branch mismatch arrangements and the basic types of branch mismatches will be explored in this chapter.

The possible outcomes on implementation of the identified types of branch mismatch arrangements will be examined. Examples of possible mismatch arrangements will be analysed to determine the impact of these arrangements on a country's tax base. This will be performed with reference to the 2017 OECD report entitled 'Neutralising the Effects of Branch Mismatch Arrangements'.

The circumstances giving rise to the mismatches will be analysed and the issues arising from the use of these arrangements will be investigated. The importance of neutralising the effects of these arrangements will be discussed in this chapter.

The challenges experienced by tax authorities in relation to these arrangements will also be discussed in this chapter.

3.2 Branch mismatch arrangements defined

In terms of the 2017 OECD report entitled 'Neutralising the Effects of Branch Mismatch Arrangements' branch mismatches occur where the residence jurisdiction (in other words the jurisdiction in which the head office is established) and the jurisdiction in which the branch is located take a different view as to the allocation of income and expenditure between the branch and head office. This also includes situations where the branch jurisdiction does not treat the taxpayer as having a taxable presence in that jurisdiction (OECD, 2017:9).

Branch mismatches are a product of inconsistencies in the domestic rules used to determine the amount of income and expenditure subject to tax in each jurisdiction where the taxpayer operates. Branch mismatches thus exploit both differences in the domestic rules for determining whether an enterprise is subject to tax in a particular jurisdiction and the amount of income and expenditure to be taken into account in calculating that tax liability. (OECD, 2017:9)

The ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping taxation in both the branch and residence jurisdiction. Unlike hybrid mismatches, which result from conflicts in the legal treatment of entities or instruments, branch mismatches are the result of differences in the way the branch and head office account for a payment made by or to the branch. Because branch mismatches turn on differences in tax accounting rather than legal characterisation the same basic legal structure may call for the application of different branch mismatch rules, depending on the accounting treatment adopted by the branch and head office (OECD, 2017:13).

Branch mismatch arrangements offer MNEs opportunities to reduce their overall tax burden by exploiting differences in the rules governing the allocation of payments between two jurisdictions thereby raising the same issues as hybrid mismatches in terms of competition, transparency, efficiency and fairness (OECD, 2017:10).

3.3 The basic types of branch mismatches

The report on branch mismatch arrangements identifies the following five basic types of mismatch arrangements (OECD, 2017:13):

- Disregarded branch structures-

  The branch does not give rise to a PE or other taxable presence in the branch jurisdiction;

- Diverted branch payments-

  The branch jurisdiction recognises the existence of the branch but the payment made to the branch (income of the branch) is treated by the branch jurisdiction as attributable to the head office, while the residence jurisdiction exempts the amount received from taxation on the grounds that the payment was made to the branch;

- Deemed branch payments-

  The branch is treated as making a notional payment to the head office which results in a mismatch in tax outcomes under the laws of the residence and branch jurisdictions;

- Double deduction branch payments-

  The same item of expenditure gives rise to a deduction under the laws of both the residence and branch jurisdictions;

- Imported branch mismatches-

  The payee (the party in the exchange who receives the payment) offsets the income from a deductible payment against a deduction arising under a branch mismatch arrangement.

The identified types of basic branch mismatch arrangements will be explored further in chapter 3.4 and 3.5.

3.4 The outcomes of the types of branch mismatches

The outcomes of the identified types of branch mismatch arrangements will now be examined:

3.4.1 Disregarded branch structures

In a disregarded branch structure the branch jurisdiction does not recognise the existence of the branch as a taxable entity and therefore does not subject any amounts received by the branch to tax. Under the laws of the residence jurisdiction the amount is seen as being received by a foreign branch and is therefore eligible for an exemption from income and tax. In the event that the amount received by the branch was paid by a related company and that payment was deductible by that related party a mismatch arises due to the fact that a deduction was obtained and the income was not taxed in any country. This gives rise to an intra-group mismatch, a D/NI outcome (OECD, 2017:14) as initially identified in chapter 2.4.2.

A D/NI mismatch could be as a result of the domestic rules operating in each jurisdiction or due to a conflict between domestic law and treaty requirements.

The resulting tax outcome from the use of a disregarded branch structure is that both the residence and the branch jurisdiction exempt or exclude the amount received from income on the grounds that the payment should be treated as received and therefore properly subject to tax in the other jurisdiction (OECD, 2017:15). The company making the payment still enjoys deduction thereof without the amount received being included as income in the hands of a counterparty.

3.4.2 Diverted branch payments

A diverted branch payment has the same structure and outcomes as an amount received by a disregarded branch except that the mismatch arises not because of a conflict in the characterisation of the branch, but rather due to a difference between the laws of the residence and branch jurisdiction as to the attribution of income received by the branch (OECD, 2017:15).

In this scenario both the residence and branch jurisdiction recognise the existence of the branch. The mismatch arises from the fact that the branch treats the amount received as if it was paid directly to the head office, while the head office continues to treat the amount as being received by the branch. As a consequence, the payment is not subject to tax in either jurisdiction, a D/NI outcome (OECD, 2017:15).

This mismatch in tax treatment could be due to a difference in the rules used by the residence and branch jurisdiction for allocating income to the branch (or a difference in the interpretation or application of those rules) or owing to specific rules in the branch jurisdiction that exclude or exempt this type of income from taxation at the branch level owing to the fact that the income is treated as attributable to a non-resident (OECD, 2017:16).

As with disregarded branch structures, the resulting tax outcome from the use of a disregarded branch structure is that both the residence and the branch jurisdiction exempt or exclude the amount received from income on the grounds that the payment should be treated as received and therefore properly subject to tax in the other jurisdiction (OECD, 2017:16).

3.4.3 Deemed branch payments

Deemed branch payments generate internal mismatches between the branch and residence jurisdictions where the rules in those jurisdictions for allocating net income between the branch and head office permit the taxpayer to recognise a deemed payment between two parts of the same taxpayer and there is no corresponding adjustment to the net income in the residence jurisdiction that takes into account the effect of the amount so received by the head office (OECD, 2017:16).

The branch is entitled to a deduction for an item that is treated as expenditure under the laws of the payer/branch jurisdiction. The payment received is disregarded in the payee/residence jurisdiction because the head office does not treat the branch as a separate enterprise for tax purposes. This means that the deduction is then set off against non-dual inclusion income, giving rise to a D/NI outcome (OECD, 2017:17). The concept of dual inclusion income will be analysed in chapter 4.2.3.

3.4.4 Double deduction branch payments

Where the same item of expenditure is treated as deductible under the laws of more than one jurisdiction tax policy concerns arise where the deduction can be offset against income that is not taxable under the laws of the other jurisdiction, thus against non-dual inclusion income (OECD, 2017:17).

Double deduction branch payments can arise in situations where the residence jurisdiction provides the head office with an exemption for branch income while still permitting it to deduct the expenditures attributable to the branch. The general exemption for branch profits provided by the residence jurisdiction allows the deduction in the branch to be set off against income that is not subject to tax in the residence jurisdiction (OECD, 2017:17).

The same expense can thus be set off simultaneously against different items of income in the residence and branch jurisdiction, giving rise to a double deduction (DD) outcome (OECD, 2017:18) as initially identified in chapter 2.4.1.

3.4.5 Imported branch mismatches

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, resulting in an indirect D/NI outcome (OECD, 2017:18).

The imported branch mismatch structure relies on the taxpayer engineering a branch mismatch under the laws of two jurisdictions (the residence and branch jurisdiction) and importing the effect of that mismatch into a third jurisdiction through a standard instrument with an otherwise orthodox tax treatment (OECD, 2017:18).

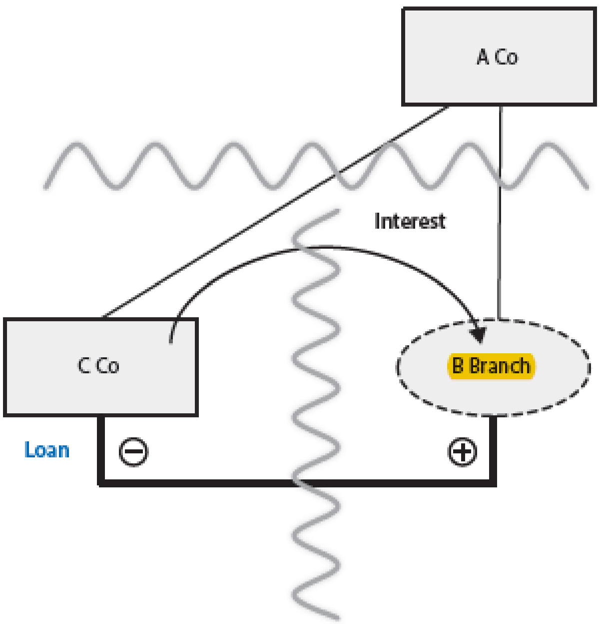
3.5 The impact of branch mismatches

The identified types of branch mismatches can be structured in various ways to attain the mismatch outcome of either a deduction with no inclusion (D/NI outcome) or a double deduction (DD outcome), whichever is appropriate. Some of the different structures employed by taxpayers and the tax effect thereof on the countries involved will now be analysed with reference to examples.

3.5.1 Disregarded branch structures

An example of a disregarded branch structure is illustrated in Figure 1 below as obtained from the 2017 OECD report on branch mismatches.

Figure 1. **Disregarded branch structure**



A Co situated in country A is the head office of B Branch situated in country B. C Co is a related company situated in country C. A Co provides a loan to C Co through B Branch. C Co pays interest to B Branch which qualifies for deduction in country C. Country B disregards B Branch for tax purposes. This may be due to the fact that B Branch does not give rise to a taxable presence under the domestic laws of Country B or does not meet the legal definition of a permanent establishment under the Country A-B tax treaty (OECD, 2017:61). Country A exempts or excludes the interest payment from taxation on the grounds that it is attributable to a foreign branch.

Neither country A nor country B included the interest income received by B Branch in the taxable income of either A Co or B Branch, whilst country C allowed a deduction of the interest paid by the related party C Co. This results in a D\NI outcome.

Disregarded branch structures thus make branch mismatches possible through taking advantage of situations where the branch jurisdiction disregards the branch (deeming it a transparent entity) and the residence jurisdiction deems the income of the branch to be exempt as it is deemed properly subject to tax in the branch jurisdiction (seeing the branch as a separate entity). The income escapes tax in both the branch and residence jurisdiction whilst the deduction is allowed by the payer jurisdiction, country C in the above example.

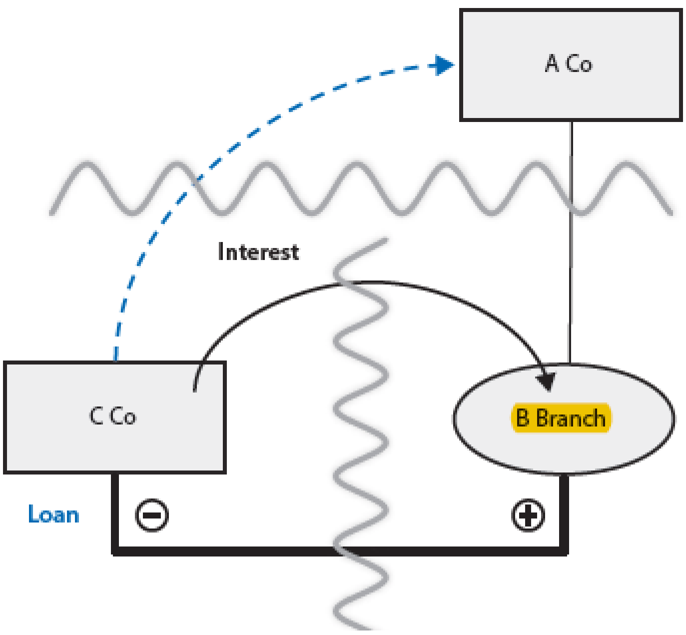
By allowing a deduction for interest paid by C Co, country C (the payer jurisdiction) reduces its tax base with a payment which does not result in taxable income being raised by a counterparty in the group to match the deduction allowed. The group as a whole is receiving a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of country C.

3.5.2 Diverted branch payments

An example of a diverted branch payment is illustrated in Figure 2 below as obtained from the 2017 OECD report on branch mismatches. This example is the same as that described in Figure 1, except that both the residence and branch jurisdiction recognise the existence of the branch.

Country B recognises the existence of B Branch as a taxable entity, but attributes the interest income received directly to A Co (the head office). Country A treats the income as being received by B Branch, a separately taxable entity. The mismatch arises either because of different allocation methods applied in each country or an exclusion that is based on the non-resident status of B Branch in country B (OECD, 2017:16).

Figure 2. **Diverted branch payment**



The outcome is the same as in the disregarded branch structure analysed in 3.5.1. Neither country A nor country B included the interest income received by B Branch in the taxable income of either A Co or B Branch, whilst country C allowed a deduction of the interest paid by the related party C Co. This results in a D\NI outcome.

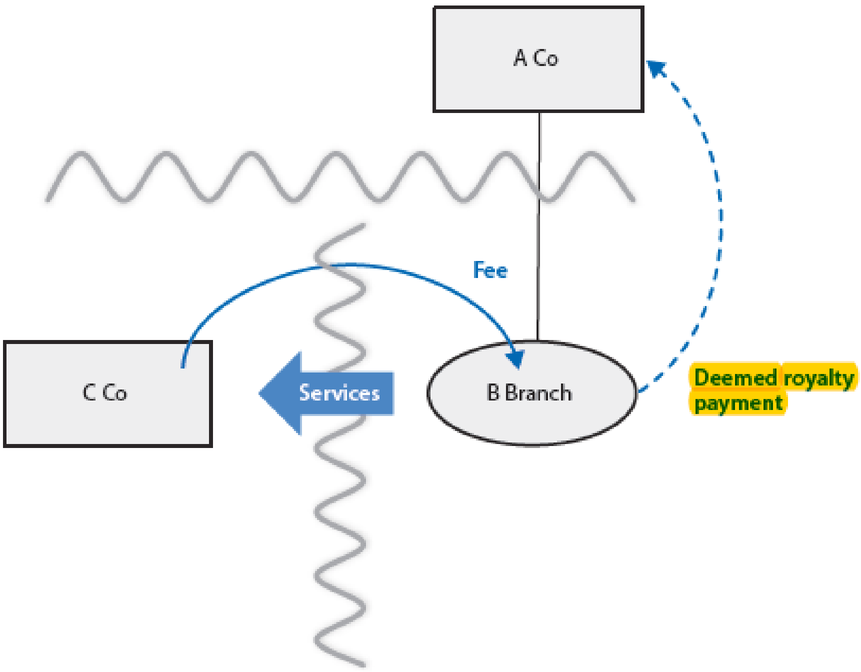
Diverted branch structures thus make branch mismatches possible through taking advantage of situations where both the residence and the branch jurisdiction exempt or exclude the income received from taxation on the basis that it is regarded as properly received and subject to tax in the other jurisdiction. The income escapes tax in both the branch and residence jurisdiction whilst the deduction is allowed by the payer jurisdiction, country C in the above example.

By allowing a deduction for interest paid by C Co, country C (the payer jurisdiction) reduces its tax base with a payment which does not result in taxable income being raised by a counterparty in the group to match the deduction allowed. The group as a whole is receiving a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of country C.

3.5.3 Deemed branch payments

An example of a deemed branch payment structure is illustrated in Figure 3 below as obtained from the 2017 OECD report on branch mismatches.

Figure 3. **Deemed branch payment**



A Co, situated in country A, is the head office of B Branch located in country B. C Co situated in country C is an unrelated party. A Co provides services to C Co through the use of B Branch. Branch B uses the intangible assets of A Co in rendering the services to C Co. B Branch compensates A Co for the use of the intangibles by paying a royalty fee to A Co. Country B deems the royalty payment to be made at arms-length and allows the payment as a deduction. Country A does not recognise the royalty payment because it attributes the ownership of the intangibles to the branch. The service income received from C Co is not recognised by country A through the application of branch exemption or exclusion for branch income available in Country A.

B Branch thus obtains a deduction for a deemed payment made to A Co which can be set off against service income earned from C Co. A Co does not include the notional payment as income because it is made internally. No profit arises in B Branch if it charges an amount equal to the deemed royalty payment made to A Co for the service rendered to C Co. Neither A Co nor B Branch would have a tax liability arising from the transaction. If A Co transacted directly with C Co, A Co would have been liable for tax on the service income earned. By using the branch structure, a tax benefit arises.

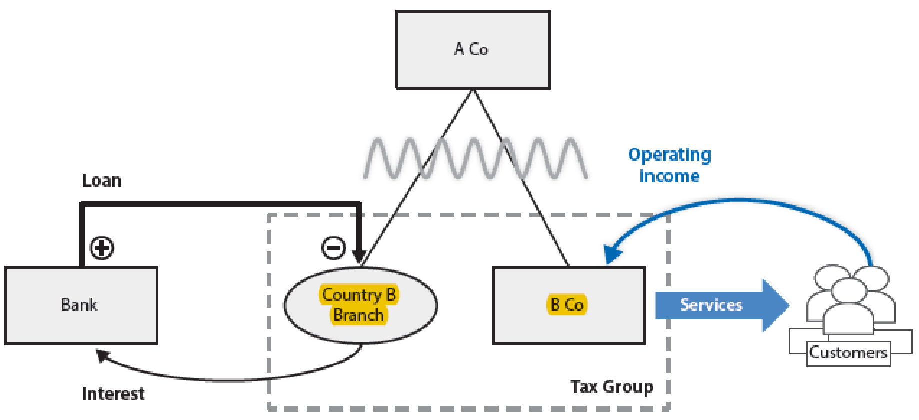
Deemed branch payment structures thus make branch mismatches possible through taking advantage of the extent to which the notional payment is set off against the branch services income. This is due to the fact that the services income is neither taxed in Country B (because it is offset by the deemed royalty payment) nor in Country A, due to an exemption or exclusion rule (Lobo & Erwin, 2016). This results in a D\NI outcome.

By allowing a deduction for the deemed royalty payment made by B Branch, country B (the payer jurisdiction) reduces its tax base with a payment which does not result in taxable income being raised by a counterparty in the group to match the deduction allowed. The group as a whole is receiving a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of country B.

3.5.4 Double deduction branch payments

An example of a double deduction branch payment structure is illustrated in Figure 4 below as obtained from the 2017 OECD report on branch mismatches.

Figure 4. **DD branch payment**



A Co situated in country A is the head office of B Branch and the parent company of B Co, a subsidiary, both situated in country B. Under Country A laws, B Branch is treated as a transparent entity and the income is therefore taxable in the hands of A Co. Country B permits B Co and B Branch to form a group for tax purposes thus allowing expenditure incurred by B Branch to be set off against the income of B Co. B Co earns operating income from providing services to unrelated customers and is allowed to set off the interest expense incurred by B Branch against the service income generated. A Co will also take the interest paid by B Branch into account when determining their tax liability. The same interest expense paid by B Branch is thus taken into account by both A Co (in country A) and B Co (in country B) against their separate taxable income.

Both A Co and B Co thus obtain a deduction for the interest expense incurred by B Branch. This reduces the overall tax liability of the group as a whole. The same interest expense is thus set off simultaneously against different items of income in the branch and residence jurisdiction. By using the branch structure, a tax benefit arises. This results in a DD outcome.

Double deduction branch payment structures thus make branch mismatches possible through taking advantage of laws allowing an expense to be deducted by a tax group in the branch country as well as by the head office. The structure could also be employed in situations where the residence jurisdiction (head office) applies a fungibility approach to the deduction of interest expense while the domestic law of the branch jurisdiction allows the branch to apply a tracing approach (Lobo & Erwin, 2016).

Peroni, Gustafson and Pugh (2008: 1464) explain the fungibility approach as follows:

> The fungibility approach recognises that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When borrowing will generally free other funds for other purposes, it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate…

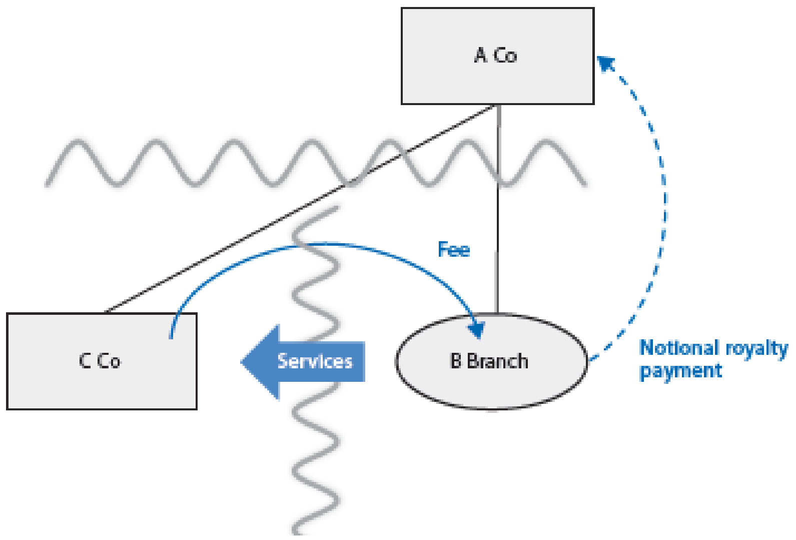
By allowing a deduction for the interest expense paid by B Branch, country A (the residence jurisdiction) reduces its tax base with an expense that has been duplicated in another jurisdiction. The group as a whole is receiving a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of country A.

3.5.5 Imported branch mismatches

An example of an imported branch mismatch structure is illustrated in Figure 5 below as obtained from the 2017 OECD report on branch mismatches.

The facts are the same as per 3.5.3 deemed branch payment structure figure 3 with the exception that C Co is a related group company.

Figure 5. **Imported branch mismatches**



B Branch obtains a deduction for deemed payment made to A Co which can be set off against service income earned from C Co. A Co does not include the notional payment as income because it is made internally. No profit arises in B Branch if it charges an amount equal to the deemed royalty payment made to A Co for the service rendered to C Co. Neither A Co nor B Branch would have a tax liability arising from the transaction. Country C allows the payment of the service fee by C Co as a deduction against C Co's taxable income. This gives rise to a D/NI outcome as C Co obtains a deduction for a payment which is effectively not included in the income of either B Branch or A Co.

By allowing a deduction for the service fee paid by C Co, country C (the related party jurisdiction) reduces its tax base with a payment which does not result in taxable income in the hands of a counterparty in the group to match the deduction allowed. The group as a whole is receiving a tax benefit it would not otherwise have been entitled to if no imported branch mismatch existed to the detriment of country C.

3.6 Conclusion

The examples of different structures employed by taxpayers and the tax effect thereof on the countries involved discussed in chapter 3.5 above are a very narrow and simplistic representation when compared to the possibilities occurring in reality. Structures employed by MNEs are rarely as straightforward and generally include complex designs using multiple jurisdictions in order to hide the true substance of the scheme. Branch mismatch arrangements structures can be extremely complex and it can be difficult to identify the actual country losing revenue.

As can be seen from the impact and outcomes of branch mismatch arrangements, as identified in this chapter, it is important for countries to consider whether they are vulnerable to tax arbitrage through branch mismatch arrangements. Although it is sometimes near impossible to identify which country's tax base has effectively been reduced by the branch mismatch arrangement, it is clear that countries housing MNEs involved in cross border trade as well as countries allowing FDI through branches will have lost revenue.

Tax authorities are seldom equipped with the knowledge or skilled in the laws of other jurisdictions that may form part of the branch mismatch arrangement structure. Furthermore, tax authorities are not focused on the treatment of the transaction by the counterparty jurisdiction other than looking at possible treaty implications. The lack of understanding of the treatment of the counterparty jurisdiction coupled with the lack of skills makes it extremely difficult for tax authorities to be in a position to identify these mismatch arrangements and respond appropriately. Even in countries where laws have been implemented as a measure to address mismatch arrangements, these laws may only cater for a certain type of mismatch and through clever planning a vast amount of structures can be designed to circumvent the application of these laws. If the possible interactions of these laws with counterparty jurisdiction are not carefully considered, situations may arise as was seen from the Danish NTT case discussed under chapter 2.6.2 where the very law that was implemented to protect the country's tax base resulted in base erosion.

Chapter 4 – Recommendations by the OECD

4.1 Introduction

This chapter will focus on the recommendations as set out in the 2017 OECD report entitled 'Neutralising the Effects of Branch Mismatch Arrangements'.

The report on branch mismatch arrangements sets out common approaches and best practices, and is not a prescribed minimum standard (EY, 2017).

The OECD recommendations to neutralise the effect of each category of branch mismatch as identified per chapter 3.3 will now be analysed.

The primary and secondary (also called defensive) rules pertaining to each recommendation and the scope thereof will be examined in this chapter.

The impact of the recommendations on both adopting and non-adopting countries will be evaluated per category of mismatch.

The concerns in relation to the adoption of the recommendations by the OECD will also be discussed in this chapter.

4.2 OECD recommendations relating to branch mismatch arrangements

4.2.1 Limitation to the scope of the branch exemption

As can be seen from the examples discussed in chapter 3.5.1 and 3.5.3 a branch exemption allowed by a head office jurisdiction (residence jurisdiction) can in some instances lead to a branch mismatch arrangement. As a response, the OECD included a recommendation to limit the scope of the branch exemption in the 2017 report on branch mismatch arrangements. While the purpose and effect of this recommendation is to reduce the frequency of branch mismatches, this recommendation is not a branch mismatch rule (OECD, 2017:25).

The OECD (2017) explains the reason for the recommendation not being a branch mismatch rule as follows:

> the residence jurisdiction may choose to bring untaxed branch income into the charge to tax not only in those cases where the reason for mismatch is due to a misallocation of the payment under the laws of the branch jurisdiction, but also where the payment qualifies for tax-free treatment in the branch on some other basis (OECD, 2017:25).

Recommendation 1.1 provides that jurisdictions providing an exemption for branch income should consider limiting the scope and operation of such an exemption so that the effect of deemed payments, or payments that are disregarded, excluded or exempt from taxation under the laws of the branch jurisdiction, are properly taken into account under the laws of the residence jurisdiction (OECD, 2017:23).

Exempting the branch income from tax in the residence jurisdiction can give rise to either branch payee mismatches or deemed branch payment mismatches. By limiting the income exempted by the head office to the amount of income actually included by the branch, the occurrence of a mismatch can be mitigated. Thus, any income that has not been included in the calculation of the branch's taxable income should not be exempted and should be included in the head office's taxable income calculation. Notional payments made by the branch to the head office should also be included in the head office's taxable income calculation.

The OECD (2017) is of the opinion that adjusting the scope of the branch exemption allowed would provide a comprehensive and transparent way of addressing branch mismatches and alleviate the payer from any need to consider whether an adjustment was required under the branch mismatch rules (OECD, 2017:24).

Limiting the scope of the branch exemption granted may possibly increase compliance as the burden of applying recommendation 1 lies with the head office, which would be able to identify the payment or deemed payment that gives rise to the mismatch more easily than the payer jurisdiction (OECD, 2017:24).

The recommendation also has the potential to eliminate a wider range of mismatches, including D/NI payments received from outside the controlled group and mismatches that result from the fact that the branch is exempt from tax, subject to a special regime or located in a jurisdiction that does not impose an income tax (OECD, 2017:24).

The OECD (2017) further states that:

> Recommendation 1.1 is based on the assumption that the intention of the residence jurisdiction in granting an exemption for branch income is to relieve that income from double taxation, so that income that is not, in fact, subject to net taxation in the branch jurisdiction should not benefit from this exemption (OECD, 2017:24).

The aim is not to call for countries to make any change to specific policy decisions taken by them, but rather modifying the scope and operation of their branch exemption to neutralise branch mismatches, whilst still attaining tax sovereignty (OECD, 2017:24). Countries still have to take into account the jurisdiction's tax treaty obligations when considering the adjustments that would be necessary to limit the scope of branch exemptions successfully.

The recommendation in the above paragraph is designed to ensure that the branch exemption operates in line with the intended tax policy settings in the residence jurisdiction, while preserving the ability of jurisdictions to determine the scope of their taxing jurisdiction consistent with their general system of taxation (OECD, 2017:25).

Even though the amount will now be required to be brought into account by the head office in applying recommendation 1, the amount may still qualify for an exemption or another type of tax relief in the residence jurisdiction owing to the nature of the income and may therefore not result in any additional tax being payable (OECD, 2017:25).

4.2.2 Branch payee mismatch rule

The second recommendation by the OECD in the 2017 branch report deals with branch payee mismatches which gives rise to D/NI outcomes. Branch payee mismatches can result from disregarded branch structures or diverted branch structures as discussed in chapters 3.4.1 and 3.4.2 and analysed in chapters 3.5.1 and 3.5.2 respectively.

Recommendation 2 calls for the payer jurisdiction to disallow the deduction to the extent that the payment is not included in the income of either the head office or the branch, if the mismatch is as a result of a disregarded branch structure or a diverted branch structure. The scope of the recommendation is limited to payments made under a structured arrangement or between members of a controlled group (OECD, 2017:27).

Each of the terms used in the recommendation have specific meanings attached to them that will now be explored.

The word 'payment' is used by the OECD to refer to any current expenditure that may be set off against ordinary income under the domestic laws of the payer jurisdiction. This includes rental paid, royalties, interest, payments for service and other deductible payments. The payment would thus result in income that has to be taken into account by the payee. A payment is deductible to the extent that the jurisdiction allows the taxpayer to offset expenditure against their ordinary income (OECD, 2017:28).

The term ‘not included in income in the head office or any branch’ refers to the fact that the payment deducted by the counterparty has not been brought into account as ordinary income in at least one of jurisdictions party to the transaction. If the payment was brought into account as ordinary income in at least one jurisdiction then there would be no mismatch for the rule to apply to (OECD, 2017:29). A payment will be treated as included in the branch or head office (and therefore outside the scope of the branch payee mismatch rule) if, after a proper determination of the character and treatment of the payment under the laws of the relevant jurisdiction, the payment can properly be considered to have been incorporated into a calculation of the payee’s ordinary income (OECD, 2017:30).

It is important to note that a payment that is taken into account by the payee under general law should not be treated as included in the ordinary income of the head office if it benefits from a specific exclusion or exemption from tax on the grounds that the payment was made to a non-resident or a foreign branch (OECD, 2017:30).

The OECD 2015 report defines a ‘structured arrangement as follows (OECD, 2015a, 110):

> 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.

The application of recommendation 2 will depend on whether the head office jurisdiction has implemented a rule, consistent with recommendation 1.1 of this report, which restricts the scope of branch exemption in the residence jurisdiction to payments that had actually been brought into the charge to taxation by the branch. If such a rule has been applied then the mismatch in tax outcomes would have been neutralised and there will be no scope for the operation of the branch payee mismatch rule (OECD, 2017:29).

A controlled foreign company (CFC) or similar regime may also impact on the application of recommendation 2. The recommendation will not apply to the extent that the taxpayer can satisfy the tax administration that the payment has been fully included under the CFC laws of the parent jurisdiction, was subject to tax at the full rate and did not qualify for any exclusion (OECD, 2017:30).

The OECD (2017) included a counterfactual test in determining whether the mismatch is a result of misallocation of payment that would fall within the ambit of recommendation 2. The branch payee mismatch rule should only apply if the payment would have been included as ordinary income if it had been paid directly to the head office.

4.2.3 Deemed branch payment rule

Recommendation 3 is aimed at the denial of a deduction for deemed branch payments which gives rise to D/NI outcomes. Deemed branch payments can occur between the branch and the head office or between two branches of the same taxpayer. The deemed payment is disregarded under the laws of the jurisdiction that is treated as receiving the payment (the payee jurisdiction) thus allowing the payer jurisdiction to set off the deduction against an item of income that is not included under the laws of the payee jurisdiction.

Recommendation 3 calls for the payer jurisdiction to disallow the deduction for the deemed branch payment to the extent that the payment is disregarded by the payee and not set off against dual inclusion income (OECD, 2017:35). The rule effectively neutralises any potential branch mismatch arising in respect of such a deemed branch payment by restricting the payer's deduction to the amount of dual inclusion income (OECD, 2017:36). Recommendation 3 only applies where the payer jurisdiction allows the taxpayer to recognise notional payments between various parts of the same taxpayer.

Each of the terms used in the recommendation have specific meanings attached to them that will now be explored.

The term 'deemed branch payment' refers to a purely notional payment between two parts of the same taxpayer which results in a mismatch in the allocation of expenditure between the payer and payee jurisdictions (OECD, 2017:36). The OECD makes it clear that the deemed branch payment rule does not apply to depreciation, losses in the value of an asset or domestic concessions such as allowances for contributed equity (OECD, 2017:36). The reason cited for this is that the purpose of these deductions is not to arrive at an accurate determination of the income that is properly subject to tax in the payer jurisdiction, but rather to unilaterally lower the effective rate of tax in order to encourage equity investment in that jurisdiction by reducing the tax distortions associated with the use of debt rather than equity (OECD, 2017:37).

A 'notional payment' is profit allocation mechanism intended to arrive at an accurate determination of the income that is properly subject to tax in the payer jurisdiction

(OECD, 2017:37). The notional payment is made in respect of functions performed, assets held or risks assumed by the head office. An actual transfer of funds may be made between the branch and head office jurisdiction and the terms of the payment may be documented as if the arrangement was between separate entities. Nevertheless, these notional payments do not have any independent legal status beyond giving effect to a proper allocation of net income between the payer and payee jurisdiction for tax purposes (OECD, 2017:37).

The deemed branch payment rule does not apply to notional payments calculated by reference to actual expenditure recognised in the accounts of taxpayer and which represents an underlying third-party expense (OECD, 2017:37).

In determining whether a payment has been 'disregarded' by a payee, the taxability of the payment must be considered. If an exclusion or exemption is applicable under the laws of the payee jurisdiction, recommendation 3 is not relevant as the payment is not subject to tax (OECD, 2017:40).

The deemed payment may be recognised by the payee jurisdiction in two ways. The payment can either be included in income or through the residence jurisdiction allocating expenditure or loss of an equivalent category to the payer jurisdiction and therefore disallowing the expenditure to be taken into account in that jurisdiction. (OECD, 2017:38). When determining whether the deemed payment belongs to an equivalent category of expense or loss, it is not necessary for the payment to be the same type as the expenditure or to have been calculated on the same basis as the expenses. A broader test on a like-kind basis should thus be applied (OECD, 2017:39).

Dual inclusion income refers to an amount that has been included in income under the laws of both the branch and head office jurisdiction. The amount will still be deemed to be dual inclusion income even if there are differences in the way the jurisdictions value that item or in the accounting period in which the income is derived (OECD, 2017:41). An item that is treated as taxable income of a branch which qualifies for a foreign tax credit will still be treated as dual inclusion income (OECD, 2017:41).

As stated in the Action 2 Report (OECD, 2015:52):

> Double taxation relief, such as a domestic dividend exemption granted by the payer jurisdiction or a foreign tax credit granted by the payee jurisdiction should not prevent an item from being treated as dual inclusion income where the effect of such relief is simply to avoid subjecting the income to an additional layer of taxation in either jurisdiction.

The application of recommendation 3 will depend on whether the head office jurisdiction has implemented a rule, consistent with recommendation 1.1 of the branch report, that results in an overall allocation of net income to the head office which would be consistent with recognising the effect of the deemed payment. If such a rule has been applied then the mismatch in tax outcomes would have been neutralised and there will be no scope for the operation of the deemed branch payment mismatch rule (OECD, 2017:36).

4.2.4 Double deduction rule

Recommendation 4 relates to the limitation of double deductions. A taxpayer involved in a cross-border structure, such as a foreign branch, may be entitled to deduct certain expenditure under the laws of two or more jurisdictions. This may lead to a DD outcome where the laws of both jurisdictions permit the deduction to be set off against an amount that is not treated as income under the laws of the other jurisdiction (OECD, 2017:44).

Recommendation 4 contains both a primary recommendation and a secondary defensive rule to address double deductions. The primary recommendation requires that the investor jurisdiction restrict the deductibility of any payment, expense or loss which is deductible under the laws of both jurisdictions, so that such amount can only be set off against dual inclusion income. The defensive rule imposes the same restriction on the payer jurisdiction. The defensive rule is only applicable when the effect of the mismatch is not neutralised in the investor jurisdiction.

The application of the rules is not affected by whether the residence jurisdiction recognises a branch in the payer jurisdiction (OECD, 2017:44). The recommendation allows the excess deductions resulting from the application of the double deduction rule to be carried-forward to another period, in accordance with a jurisdiction’s ordinary rules for the treatment of net losses, and applied against dual inclusion income in that period (OECD, 2017:44). The rule further does not limit the deductibility of stranded losses. A stranded loss arises when a deduction resulting in a loss for the branch cannot be set off against the income of any person under the laws of the investor jurisdiction (OECD, 2015a:73).

Each of the terms used in the recommendation have specific meanings attached to them that will now be explored.

The term ‘double deduction’ refers to a deduction of the same payment, expense or loss in both the payer jurisdiction and the investor jurisdiction (OECD, 2017:43). The term ‘expense’ includes non-cash items such as depreciation or amortisation (OECD, 2017:44).

The differences between the rules of the two jurisdictions in determining the value and timing of the payment, expense or loss will not generally result in a mismatch for the purpose of this recommendation (OECD, 2017:45).

In determining which payments, expenses or losses result in double deduction a comparison has to be done between the domestic tax treatment of the items and their treatment under the laws of the other jurisdiction. Such a line-by-line comparison would be impractical in commercial branch operations or in more complex cases. The recommendation allows countries to ‘choose an implementation solution that is based, as much as possible, on existing domestic rules, administrative guidance, presumptions and tax calculations while still meeting the basic policy objectives of recommendation 4 (OECD, 2017:45).

The recommendation also proposes a possible alternative method where the taxpayer could determine the amount of double deductions on an aggregate basis. This can be done by comparing the total deductions claimed for actual expenditure and loss in each jurisdiction against the taxpayer’s total relevant expenditures. The excess determined may be treated as a double deduction to the extent it cannot be explained by reference to differences in timing or valuation. The comparison may be performed on a category by category basis, a branch by branch or a whole of entity basis, with the condition that the taxpayer should only be expected to make the adjustment in one jurisdiction (OECD, 2017:45).

In the event that the residence jurisdiction provides a general exemption from branch income, a mismatch would still occur as the deduction is likely to end up being set off against non-taxable income in the residence jurisdiction (OECD, 2017:46).

It is important to note that the double deduction rule limits the deduction only to the extent that the duplicate deduction was actually applied against non-dual inclusion income in the counterparty jurisdiction. Taxpayers with taxable branch operations could thus continue to deduct losses in respect of their offshore investment and adjustments would only need to be made if and when the loss was applied against non-dual inclusion income in the counterparty jurisdiction (OECD, 2017:47).

4.2.5 Imported branch mismatch rule

Recommendation 5 addresses the treatment of imported branch mismatches. An imported branch mismatch arises where a deductible payment directly or indirectly funds deductible expenditure under a branch mismatch arrangement. This is done by shifting the effect of an offshore branch mismatch into the domestic jurisdiction through the use of an instrument such as an ordinary loan (OECD, 2017:50). The absence of effective branch mismatch rules in offshore jurisdictions creates the opportunity for imported branch mismatches to generate the mismatch in tax outcomes which can then be imported into the payer jurisdiction (OECD, 2017:50).

Recommendation 5 calls for the payer jurisdiction to deny a deduction for any payment made under an imported branch mismatch arrangement to the extent that such payment directly or indirectly funds deductible expenditure under a branch mismatch arrangement. The recommendation does not apply to the extent that one of the jurisdictions has made an equivalent adjustment in respect of such branch mismatch (OECD, 2017:49).

Each of the terms used in the recommendation have specific meanings attached to them that will now be explored.

An 'imported branch mismatch arrangement' is defined as a transaction or series of transactions entered into either between members of a controlled group or as part of a structured arrangement to which the payer is a party, that directly or indirectly funds deductible expenditure under a branch mismatch arrangement (OECD, 2017:49).

The term 'payment' has the same meaning as discussed under point 4.2.2. In order to qualify as a payment made under an imported branch mismatch arrangement the payment should be deductible under the laws of the payer jurisdiction and should give rise to ordinary income under the laws of the payee jurisdiction. It is important to note that a payment made to a person who is not a taxpayer in any jurisdiction will not be treated as an imported mismatch payment (OECD, 2017:50).

The term 'funding expenditure under a branch mismatch arrangement' includes situations where the income from the payment is directly set off against a deduction under a branch mismatch arrangement or where the payment is indirectly set off against that deduction through a chain of interconnected payments or group relief surrenders between intermediate taxpayers (OECD, 2017:51). It excludes an arrangement where that payment is treated as dual inclusion income.

Tracing and priority rules to be used by taxpayers and tax administrations to determine the extent to which a payment should be treated as set off against a deduction under an imported mismatch arrangement is described in the OECD's 2015 report on Action 2 (OECD, 2015:84-89). The tracing and priority rules are summarised in the 2017 report as follows (OECD, 2017:51);

> These rules start by identifying the payment that gives rise to a hybrid mismatch (a "direct hybrid deduction") and then determine the extent to which that hybrid deduction has been funded (either directly or indirectly) out of payments made by taxpayers that are subject to the imported mismatch rule ("imported mismatch payments").

The OECD (2017) states that 'the key objective of the imported branch mismatch rule is to maintain the integrity of the other branch mismatch rules by removing any incentive for multinational groups to enter into these arrangements' (OECD, 2017:50).

4.3 The impact of the recommendations per category of mismatch

The impact of the recommendations on both adopting and non-adopting countries will now be evaluated per category of mismatch.

4.3.1 Limitation to the scope of the branch exemption

Recommendation 1 states that jurisdictions providing an exemption for branch income should consider limiting the scope and operation of such exemption so that the effect of deemed payments, or payments that are disregarded, excluded or exempt from taxation under the laws of the branch jurisdiction, are properly taken into account under the laws of the residence jurisdiction (OECD, 2017:53).

As this recommendation only affects the residence jurisdiction, a discussion on the impact on the branch jurisdiction will not be undertaken.

4.3.1.1 Impact on adopting residence jurisdiction

When the residence jurisdiction implements a rule similar to recommendation 1 which adjusts the scope of the branch exemption allowed, any income that has not been included in the calculation of the branch's taxable income will not be exempted from tax and will be included in the head office's taxable income calculation.

This allows the residence jurisdiction to tax income subject to tax that is currently escaping the tax net due to branches taking advantage of the branch exemption afforded to them. The income will be properly taxed by the residence jurisdiction resulting in additional tax payable in the residence jurisdiction, whilst also ensuring that the deduction allowed in the payer jurisdiction does not result in a D\NI outcome as discussed in chapters 3.5.2 and 3.5.3.

4.3.1.2 Impact on non-adopting residence jurisdiction

Should the residence jurisdiction decide not to adopt recommendation 1 and still allow the full branch exemption even though the amounts exempted have not been subject to tax in the branch jurisdiction, it will be allowing the erosion of its tax base through the use of branch mismatch arrangements. Furthermore, the implementation of recommendations 2 and 3 is subject to recommendation 1. Thus, if the residence country does not implement recommendation 1 the payer jurisdiction can implement recommendation 2 or 3, whichever is relevant to the specific case, disallowing the deduction and increasing its tax base with an amount that should have been subject to tax in the residence jurisdiction.

The adoption of recommendation 1 will thus be beneficial to the residence jurisdiction as it increases its tax base by taxing income which is subject to tax, but has been escaping taxation through tax arbitrage exploiting branch exemptions.

4.3.2 Branch payee mismatch rule

Recommendation 2 provides that the payer jurisdiction should deny a deduction for a payment that gives rise to a D/NI outcome to the extent that the mismatch is a result of:

a. differences in the allocation of payments between the residence and the branch jurisdiction or between two branch jurisdictions (diverted branch); or

b. the fact that the payment is to a disregarded branch (OECD, 2017:53).

As this recommendation only affects the payer jurisdiction, a discussion on the impact on the residence and branch jurisdiction will not be undertaken.

4.3.2.1 Impact on adopting payer jurisdiction

When the payer jurisdiction implements recommendation 2, the deduction which does not result in taxable income being raised by a counterparty in the group will be disallowed. This protects the payer jurisdiction's tax base by not allowing a payment which is not matched against taxable income in either the residence or branch jurisdiction to be deducted. The group tax benefit is extinguished and the payer jurisdiction's tax base is not reduced with a branch mismatch arrangement.

Should the residence jurisdiction implement a rule similar to recommendation 1, the payer jurisdiction would not be able to apply recommendation 2 and will have to allow the deduction. The payment allowed as a deduction would be raised as taxable income in the residence jurisdiction and would thus not result in a D\NI outcome. The group tax benefit will still be extinguished and a branch mismatch would no longer exist.

4.3.2.2 Impact on non-adopting payer jurisdiction

Should the payer jurisdiction decide not to implement recommendation 2, its tax base will be reduced with a payment which does not result in taxable income being raised by a counterparty in the group. The group as a whole will receive a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of the payer jurisdiction. Should the residence jurisdiction also fail to implement a rule similar to recommendation 1, the branch mismatch arrangement will not be neutralised.

The adoption of recommendation 2 will thus be beneficial to the payer jurisdiction as it increases its tax base by denying a deduction which does not result in taxable income being raised by a counterparty in the group.

4.3.3 Deemed branch payment rule

Recommendation 3 provides that the payer jurisdiction should deny a deduction for a deemed branch payment to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income (OECD, 2017:54).

As this recommendation only affects the branch jurisdiction, a discussion on the impact on the residence jurisdiction will not be undertaken.

4.3.3.1 Impact on adopting branch jurisdiction

When the branch jurisdiction implements recommendation 3, the deemed payment which does not result in taxable income being raised by the residence jurisdiction will be disallowed. This protects the branch jurisdiction's tax base by not allowing a deemed branch payment which is set off against an amount that is not dual inclusion income as a deduction. The group tax benefit is extinguished and the branch jurisdiction’s tax base is not reduced with a deemed payment.

Should the residence jurisdiction implement a rule similar to recommendation 1, the payer jurisdiction would not be able to apply recommendation 3 and will have to allow the deduction. The payment allowed as a deduction would be raised as taxable income in the residence jurisdiction and would thus not result in a D\NI outcome. The group tax benefit will still be extinguished and a branch mismatch would no longer exist.

4.3.3.2 Impact on non-adopting branch jurisdiction

Should the branch jurisdiction decide not to implement recommendation 3, its tax base will be reduced with a deemed payment which does not result in taxable income being raised by a counterparty in the group. The group as a whole will receive a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of the branch jurisdiction. Should the residence jurisdiction also fail to implement a rule similar to recommendation 1, the branch mismatch arrangement will not be neutralised.

The adoption of recommendation 3 will thus be beneficial to the branch jurisdiction as it increases its tax base by denying a deduction that is being set off against an amount that is not dual inclusion income.

4.3.4 Double deduction rule

Recommendation 4 provides that to the extent that a double deduction outcome allows the deduction to be set off against an amount that is not dual inclusion income:

a. the deduction should be denied in the residence jurisdiction; and

b. where the deduction is not denied in the residence jurisdiction, then the deduction should be denied in the branch jurisdiction (OECD, 2017:54).

As this recommendation affects both the residence jurisdiction and the branch jurisdiction a discussion on the impact on both jurisdictions will be undertaken.

4.3.4.1 Impact on adopting residence jurisdiction

When the residence jurisdiction implements recommendation 4 the double deduction, to the extent that the branch jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income, will be disallowed. This protects the residence jurisdiction's tax base by not allowing a double deduction. The group tax benefit is extinguished and the residence jurisdiction's tax base is not reduced with a double deduction.

4.3.4.2 Impact on non-adopting residence jurisdiction

Should the residence jurisdiction decide not to implement recommendation 4, its tax base will be reduced with a double deduction which is set off against an amount that is not dual inclusion income.

The adoption of recommendation 4 will thus be beneficial to the residence jurisdiction as it increases its tax base by denying a double deduction that is being set off against an amount that is not dual inclusion income.

4.3.4.3 Impact on adopting branch jurisdiction

If the residence jurisdiction does not implement recommendation 4's primary rule, the branch can opt to use the defensive rule contained in recommendation 4. Should the branch jurisdiction implement the defensive rule, the branch jurisdiction would be able to disallow the deduction and the branch jurisdiction would thus benefit. The double deduction would be disallowed and a DD outcome would no longer exist. The group tax benefit will be extinguished and a branch mismatch would no longer exist.

4.3.5 Imported branch mismatch rule

Recommendation 5 states that the payer jurisdiction should deny a deduction for any payment made under an imported branch mismatch arrangement to the extent that such payment directly or indirectly funds deductible expenditure under a branch mismatch arrangement (OECD, 2017:55).

As this recommendation only affects the payer jurisdiction, a discussion on the impact on the residence and branch jurisdiction will not be undertaken.

4.3.5.1 Impact on adopting payer jurisdiction

When the payer jurisdiction implements recommendation 5 the deduction funding deductible expenditure under a branch mismatch arrangement will be disallowed. This protects the payer jurisdiction's tax base by not allowing a payment which is not matched against taxable income in either the residence or branch jurisdiction to be deducted. The group tax benefit is extinguished and the payer jurisdiction's tax base is not reduced with a branch mismatch arrangement.

4.3.2.2 Impact on non-adopting payer jurisdiction

Should the payer jurisdiction decide not to implement recommendation 5, its tax base will be reduced with a payment funding deductible expenditure under a branch mismatch arrangement. The group as a whole will receive a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of the payer jurisdiction.

The adoption of recommendation 5 will thus be beneficial to the payer jurisdiction as it increases its tax base by denying a deduction funding deductible expenditure under a branch mismatch arrangement.

4.4 Concerns relating to the adoption of the recommendations

There are a number of concerns that arise when contemplating the adoption of the recommendations as discussed above.

The size of commercial branch operations, the volume of transactions and the complexity of the rules governing the calculation and allocation of income between the head office and branches may make it difficult for the taxpayer to establish to the satisfaction of a tax authority that a payment that has not been included in one jurisdiction, has in fact been included in another (OECD, 2017:30). This may result in a tax authority raising an assessment to neutralise the supposed branch mismatch arrangement when in fact none actually exists as the payment was included in one of the other jurisdictions.

The implementation of the rules may have a significant impact on the tax liability of MNEs conducting business in South Africa and may encourage these entities to restructure their operations by conducting business through non-adopting countries. It may also impact FDI and the competitiveness of home-grown multinationals (Davis Tax Committee, 2017a:21).

Proper planning and co-ordination in the implementation and application of the branch mismatch rules is vital to ensure that the rules are effective and to minimise compliance and administration costs for taxpayers and tax administrations (Davis Tax Committee, 2017a:20).

It is important to note that the technical requirements to trace and link the deductibility of branch mismatch arrangements with the treatment in the counterparty jurisdictions can be complex and resource intensive for tax authorities (Davis Tax Committee, 2017a:21). Tax authorities may lack the necessary skills and resources to effectively conduct audits and investigations into branch mismatch arrangements to determine whether the recommendations should be applied or not to the transaction in question.

Tax authorities will generally be relying on the taxpayer to provide them with copies of the group calculations together with supporting evidence of the adjustments (OECD, 2017:51). If the taxpayer does not provide accurate and complete information to the tax authority, possible branch mismatch arrangements may not be properly identified and addressed.

4.5 Conclusion

The recommendations provided by the OECD in mitigating branch mismatch arrangements are complex and contain several exclusions and provisions. There are numerous types of branch mismatches that could be occurring and it is impossible for the OECD to cover every possible structure that may arise in the recommendations presented.

Furthermore, the level of complexity involved in these branch hybrid rules, added to the existing complexity already found in the BEPS Action 2 recommendations, suggests that some countries may find it difficult to introduce them in full. There also remains the risk of economic double taxation or inconsistent application, thereby impacting other tax, commercial or regulatory outcomes (PWC, 2017).

There are several factors that need to be taken into account when determining whether the recommendations as set out by the OECD should be adopted or not. The challenges that will be experienced and the possible consequences thereof need to be weighed against the potential yield arising from adopting the recommendations.

The decision of whether to adopt the recommendations relating to branch mismatch arrangements as set out by the OECD should be made with consideration to the attainment of the country’s tax sovereignty and the alignment of tax policies with the country’s economic policies.

The Davis Tax Committee states that balancing between the protection of the tax base and the competitiveness of the economy is of utmost importance. The recommendations should not be adopted without taking into consideration the need to encourage FDI in light of the NDP and also the need to preserve the competitiveness of South Africa's economy on the international scene (Davis Tax Committee, 2017b:32).

Chapter 5 – Response of selected countries to the OECD recommendations

5.1 Introduction

The views of stakeholders and academics on the adoption of BEPS Action Plans and specifically the recommendations set out by the OECD on neutralising the effects of branch mismatch arrangements will now be investigated.

The different options available to countries in adopting the OECD recommendations and the approaches to be followed will be investigated in this chapter. This will be done from New Zealand's perspective based on a regulatory impact assessment performed on hybrid mismatch arrangements.

This chapter will examine the approaches taken by selected countries including the United Kingdom, New Zealand and Australia in adopting the recommendations by the OECD in relation to hybrid mismatch arrangements as well as branch mismatch arrangements where applicable. These countries were selected as they have already implemented the recommendations of the OECD Action 2 BEPS report into their domestic legislation.

The issues considered and the amendments made to domestic law in this regard will be examined. The amendments specifically aimed at branch mismatch arrangements will be unpacked and compared to the OECD recommendations as discussed in chapter 4.2.

The challenges experienced by the adopting countries will also be examined.

5.2 Views on the adoption of BEPS Action Plans

The OECD BEPS Action Plan and the related recommendations have elicited differing views and criticisms from stakeholders and academics. Supporters of the recommendations agree with the need for such policy changes and have taken steps to incorporate and address the recommendations in their domestic law. Detractors on the other hand believe that there are fundamental flaws in the recommendations and that the implementation of the recommendations will not have the desired effect.

Criticism has been raised that the OECD agenda has been driven by the interests of developed countries and that the interests of developing countries are not being addressed (Oguttu, 2016:20). Oguttu (2016) states that the BEPS Action Plan portrays a lack of focus or understanding of the specific need of developing countries and embodies rules set by a few countries, thereby reinforcing a system that exacerbates global inequality (Oguttu, 2016:20)

Oguttu (2016) further states that:

> The OECD's approach has also been criticised for not addressing basic fundamental international tax reform, or re-examining the basic principles of the international tax system that are pivotal in addressing BEPS – such as the allocation of tax income between residence and source countries. The OECD chose to focus on curtailing sophisticated tax avoidance schemes by strengthening existing anti-avoidance provisions, to ensure that they are more effective in curtailing BEPS under modern business models. However, since taxpayers have manipulated these very anti-avoidance provisions to a point of being ineffective, there is little reason to expect that strengthening the rules further will prevent BEPS (Oguttu, 2016:20).

Boidman and Kandev. (2014) is of the opinion that the fundamental weakness of the action 2 proposals is that the OECD expect countries to engage in irrational legislative behaviour. By adopting the recommendations resident MNEs would be negatively affected without a hope of increased tax revenue for the resident jurisdiction. Some recommendations will also lead to effectively protecting the tax base of other countries whilst still leaving the residence jurisdiction open to exposure to tax arbitrage (Boidman & Kandev, 2014:1244). The biggest drawback pointed out by Boidman and Kandev (2014) is the insurmountable difficulties relating to imported mismatches in multilateral situations.

Mechtler and Wong (2016:34) are of the opinion that affected taxpayers are likely to restructure their existing arrangements in an effort to preserve the effects for tax purposes. As a result, taxpayers have the opportunity to replace their hybrid mismatch arrangements by other structures which may still achieve a D/NI outcome while being explicitly outside the operation of the recommendations proposed by the OECD (Mechtler & Wong, 2016:34). This will render the recommendations redundant.

The United States believes that the 'best way to address the potential problem of B.E.P.S. is to enact comprehensive tax reforms that lower the corporate rate to a more internationally competitive level and modernize the badly outdated and uncompetitive U.S. international tax structure' (Cadesky, 2014:10).

Wright (2016) is of the opinion that, there may be a finite pot of taxable income that is 'up for grabs' on hybrid mismatches between territories.

Patterson and North (2017:18) notes that the fact that the hybrid mismatch rules do not look into which country actually lost revenue is at odds with the BEPS mantra that profits should be taxed where the economic activities that generate the profits are performed and where value is created.

Vial (2016) notes that complexity of the rules, overreach and the risk of an increased cost of capital deterring inbound investment, are all legitimate concerns when considering adopting the recommendations.

The United Kingdom, in contrast to the above detractors, is an avid and vocal supporter of the OECD and its BEPS project (Bhogal & Fryer, 2016:1). The United Kingdom is also the first country to formalise the recommendations into actual law and enact the provisions as part of their legislation.

5.3 Available options in adopting the OECD recommendations

New Zealand identified four options in adopting the OECD recommendations in the development of their regulatory proposal informing final tax policy decisions to be taken by Cabinet. These options closely represent the possible approaches a country can take in the adoption of the OECD recommendations. An analysis of the options will be undertaken in this research report to determine the advantages and disadvantages of each approach.

The options identified are mutually exclusive and can be regarded as four points on a decision spectrum measuring how closely (if it all) a country aligns itself with the OECD recommendations (Inland Revenue New Zealand, 2017a:8).

5.3.1 Option 1: Strict adoption of OECD recommendations

Option 1 is to strictly adopt the recommendations as described by the OECD into domestic law. This option would deal with the range of mismatch arrangements targeted by the OECD to the extent they are found in or affect the relevant country (Inland Revenue New Zealand, 2017a:8).

The advantage is that there would be proper interaction between the tax systems of other countries that similarly adopt the OECD recommendations into their domestic law. Mismatch opportunities will be neutralised and it should result in an increase in tax revenue. It will increase fairness and equity between taxpayers as a select group can no longer use hybrid mismatch arrangements to reduce their tax liability (Inland Revenue New Zealand, 2017a:10).

The disadvantage is that some countries, such as developing countries, may not have a need for such an extensive set of rules as only a specific set of branch mismatch arrangements are relevant to them. Another factor to consider is the increased compliance cost on the taxpayers and compliance burden on the tax administration. In order for the taxpayer to ensure compliance with the extensive rules implemented additional costs will be incurred. Some of the recommendations may be contrary to current domestic laws and additional legislative provisions may need to be amended to ensure coherence (Inland Revenue New Zealand, 2017a:10).

Option 1 will be far too onerous to implement for the majority of countries and may include irrelevant or conflicting provisions in comparison to current domestic laws.

5.3.2 Option 2: Tailored adoption of OECD recommendations

Option 2 is to adopt the core principles of the OECD recommendations with suitable modifications and variations to take into account what is appropriate for the relevant country (Inland Revenue New Zealand, 2017a:8).

This tailored option is comparable to Option 1 as it involves introducing hybrid rules that are consistent with the recommendations of the OECD unless there is a persuasive reason to depart from the OECD approach (Inland Revenue New Zealand, 2017a:8). This option would ensure that the policy is similar to what other countries will adopt, but still addressing the country’s particular issues.

Option 2 also provides for instances where the country’s existing tax laws are sufficient or require relatively minor amendments to achieve the effect intended by an OECD recommendation (Inland Revenue New Zealand, 2017a:8).

In comparison to Option 1, option 2 is a more focused approach and the compliance cost will be lower than with a strict adoption of the OECD recommendations. Mismatch opportunities will be neutralised and it should result in an increase in tax revenue. It will increase fairness and equity between taxpayers as a select group can no longer use hybrid mismatch arrangements to reduce their tax liability (Inland Revenue New Zealand, 2017a:10).

5.3.3 Option 3: Targeted hybrid rules

Option 3 is to introduce targeted hybrid rules that address only the significant mismatches that the Government is aware of (Inland Revenue New Zealand, 2017a:8).

This targeted option would only be addressing the current hybrid mismatch arrangements affecting the country. It has the advantage that unnecessary rules targeted at arrangements which are not currently applicable to the country will not be enacted. This will reduce compliance costs on the taxpayer and the compliance burden on the tax administration as less legislation needs to be enacted and enforced.

The disadvantage is that only branch mismatch arrangements falling within the enacted rules will be addressed and the opportunity to take advantage of the arrangements that have not been targeted exists. The tax benefit from these arrangements will be somewhat reduced, but the increase in tax revenue will be reduced by the possible other mismatch opportunities which still remain available (Inland Revenue New Zealand, 2017a:10).

Options 3 carries the risk that taxpayers will change their arrangements in order to fall outside the scope of the targeted hybrid rules enacted and instead exploit the mismatches that the government deemed not to be applicable to the country.

5.3.4 Option 4: Status quo- No action

This option relies on a country’s existing law, such as the General anti-avoidance rule (GAAR) to counter hybrid mismatch arrangements (Inland Revenue New Zealand, 2017a:8).

The advantage of this option is that the increased compliance costs and administrative costs of the other options are avoided.

The status quo option also takes into account that other countries have introduced or will introduce their own hybrid mismatch rules, some of which will neutralise hybrid mismatch arrangements relating to the country.

In the event that the GAAR is not effective in counteracting the mismatches occurring, the country will be losing revenue that may have been taxable if the recommendations had been enacted. The country may also lose out on revenue that would have been subject to tax if the counterparty jurisdiction is an adopting country and they invoke the secondary rules.

5.4 Approaches taken by selected countries

The approaches taken by the selected countries such as the United Kingdom, Australia and New Zealand in adopting the recommendations of the OECD branch report will now be discussed and analysed.

5.4.1 The United Kingdom

As indicated in chapter 5.1, the United Kingdom is an active OECD supporter and was one of the first countries to enact provisions in their domestic legislation based on the OECD BEPS action plans. The United Kingdom was the first country to introduce the OECD hybrid mismatch recommendations in their domestic law (EY, 2016).

The United Kingdom Government included legislation implementing the recommendations of the OECD Action 2 BEPS report in the Finance Act 2016, with an effective date of 1 January 2017 (Bhogal & Fryer, 2016:2).

The legislation enacted is focused on the following categories (Wright, 2016):

- Hybrid instruments;
- Hybrid transfer arrangements;
- Hybrid entities;
- Companies with permanent establishments (PEs) outside their state of residence; and
- Dual resident companies.

The legislation was included in sections 259A-259NF of Part 6A to the Taxation (International and Other Provisions) Act 2010 (TIOPA) by Schedule 10 contained in the Finance Act 2016 (No.2) B 2016. The legislation only includes the recommendations relating to hybrid mismatch arrangements and does not include the recommendations concerning branch mismatch arrangements as the branch report was only issued in July 2017.

When comparing the legislation enacted by the United Kingdom to the recommendations from the OECD relating to hybrid mismatch arrangements, it would appear that the United Kingdom applied their version of Option 2 as discussed in chapter 5.3.2 (Inland Revenue New Zealand, 2017a:8).

The tailored approach chosen by the United Kingdom was not expected to have any impact on entities undertaking normal commercial transactions. It would only affect MNEs that use contrived tax planning arrangements to exploit mismatches in international tax systems (HM Revenue and Customs, 2016).

The amendments enacted by the United Kingdom will be discussed in more detail under chapter 5.6.1.

5.4.2 New Zealand

New Zealand is another country that supports the BEPS initiatives and implemented the recommendations of the OECD Action 2 BEPS report in their domestic legislation.

Elliffe, Peters, and Vial (2016) stated during the IFA 2017 Rio de Janeiro Congress that 'the New Zealand Government viewed BEPS as a global problem that required an internationally coordinated response. Accordingly, it supported a high level of engagement with the OECD BEPS initiatives' (Elliffe, Peters, & Vial, 2016:2).

As indicated in chapter 5.3, New Zealand undertook a regulatory impact assessment on hybrid mismatch arrangements informing final tax policy decisions to be taken by Cabinet. The assessment was done in consultation with stakeholders in order to determine the possible benefits, costs to be incurred, options of implementation and the possible implementation risks.

During the regulatory impact assessment consultations were held with officials representing Australia and the United Kingdom, as well as the OECD secretariat, to ensure that the proposed rules work as intended, and do not give rise to inadvertent double taxation or non-taxation (Inland Revenue New Zealand, 2017a:7).

The Taxation (Neutralising Base Erosion and Profit Shifting) Act 16 of 2018 came into force on 1 July 2018, with the exception of some sections which came into force on the day on which the Act received the Royal assent, 27 June 2018. This Act included amendments to the Income Tax Act 2007 in part 1 of the Act as well as amendments to the Tax Administration Act 1994 in part 2 of the Act.

The amendments to the Income Tax Act 2007 include so-called 'linking rules'. The linking rules effectively adjust the tax outcomes under a hybrid or branch mismatch in one country in order to align them with the tax outcomes in the other country (Inland Revenue New Zealand, 2018:2). The linking rules are introduced through the inclusion of a new subpart FH in the Income Tax Act 2007. Other tax regimes such as the foreign investment fund, withholding tax on non-resident passive income and thin capitalisation rules were also amended with the relevant provisions affecting hybrid and branch mismatch arrangements (Inland Revenue New Zealand, 2018:2).

The amendments will be discussed in more detail under chapter 5.6.2.

New Zealand opted to apply Option 2, as discussed above in chapter 5.3.2, in adopting the recommendations of the OECD Action 2 BEPS report after conducting the regulatory impact assessment.

5.4.3 Australia

Australia is also a supporter of the BEPS initiatives and has also implemented the recommendations of the OECD Action 2 BEPS report in their domestic legislation.

According to the Australian Board of Taxation, Australia has played an integral role in leading the G20 agenda and contributing to the OECD's work on addressing BEPS (Board of Taxation Australia, 2016:13).

The board further states that:

> The Australian Government is committed to eliminate, in partnership with the OECD and through the G20, the tax advantage arising from the use of hybrid instruments and hybrid entities whilst ensuring investment activity is not compromised and that Australia remains an economically competitive place to do business (Board of Taxation Australia, 2016:14).

Australia tasked the Australian Board of Taxation with consulting on the implementation of hybrid mismatch rules as developed by the OECD. The Board of Taxation identified an implementation strategy which has regard to the economic costs for Australia and the compliance costs for taxpayers.

The Australian Government included legislation implementing Action 2 in the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018, with an effective date of 1 January 2019. The Bill included amendments to the Income Tax Assessment Act 1997 in part 1 of the Act as well as amendments to the Income Tax Assessment Act 1936 in part 2 of the Act.

The legislation enacted includes the recommendations relating to hybrid mismatch arrangements and also includes some provisions concerning branch mismatch arrangements.

Australia focused particularly on the financial services industry where branches have been widely used, particularly by banks. During the 2017 Financial Services Taxation Conference it was stated that around 80% of foreign banks operate through a PE in Australia as opposed to a subsidiary. Furthermore, bank branches will not only transact with third parties but enter into a large number of internal 'dealings' with their head office and other branches. (Pinson, Wood, & Hu, 2017:4)

The rules enacted do not contain any de minimis provision or materiality exemptions. No 'grandfathering' relief will be granted for existing arrangements.

The amendments will be discussed in more detail under chapter 5.6.3.

Australia applied Option 2, as discussed above in chapter 5.3.2, in adopting the recommendations of the OECD Action 2 BEPS report based on the implementation strategy review conducted by the Board of Taxation.

5.5 Issues considered

There are numerous issues to consider in determining which of the options as discussed in chapter 5.3 will be most suitable for a country when adopting the recommendations of the OECD Action 2 BEPS report. New Zealand identified a number of issues to be considered as part of their regulatory impact assessment. Further issues to be considered as per the OECD implementation guidance will also be discussed.

5.5.1 Issues per New Zealand regulatory impact assessment

The issues taken into account when determining which approach to choose were as follows:

5.5.1.1 Efficiency of compliance

A compliance cost for taxpayers is an important issue to be taken into account when deciding on the possible implementation of the recommendations of the OECD Action 2 BEPS report. Additional costs will have to be incurred by taxpayers to obtain an understanding of the rules and to review their current arrangements to identify whether any of the rules will apply to these. Restructuring costs may also arise if taxpayers transition to non-hybrid arrangements in order to fall outside the scope of the rules. Compliance costs should be minimised as far as possible to reduce the impact of the implementation on taxpayers (Inland Revenue New Zealand, 2017a:9). Based on the analysis performed on the available options per chapter 5.3, Option 1 would have the highest compliance cost. Options 2 and 3 will also increase compliance cost, but the fact that the only tailored or targeted rules are implemented slightly reduces the cost. Regardless of which of the three options to adopt the recommendation are actually chosen, some form of compliance cost will have to be incurred by the taxpayer.

5.5.1.2 Efficiency of administration

The efficiency of the Tax Administration in addressing branch mismatch arrangements is influenced by the administrative costs incurred, and the training and expertise of the tax auditors. Staff involved in dealing with the branch mismatch arrangements need to develop their understanding of the topic and should be properly skilled though training interventions. The upskilling and training of staff to understand the recommendations and law changes and to become equipped with dealing with different taxpayer structures will carry a large administration cost. This investment in skilled staff should have long enduring benefits and should be offset by increased revenue from addressing the mismatches previous left untaxed. The systems used by the Tax Administrations may require modernisation in order to identify the possible risk and to process the resultant audit assessments. Tax Administrations should attempt to minimise Administrative costs as far as possible by streamlining processes (Inland Revenue New Zealand, 2017a:9).

5.5.1.3 Neutrality

It is important that the tax system prejudice economic decisions as little as possible (Inland Revenue New Zealand, 2017a:9). This is in line with the concept of capital export neutrality and capital import neutrality as discussed in chapter 2.5.1.

By exploiting branch mismatch arrangements these branches can currently operate at lower effective tax rates when compared with other businesses. This can affect international investment decisions by making investment decisions based on whether a mismatch is available rather than on commercial grounds. More productive investment opportunities may be forgone in favour of the tax benefit than can be obtained through the use of businesses taking advantage of branch mismatch arrangements (Inland Revenue New Zealand, 2017a:11).

By implementing the recommendations of the OECD Action 2 BEPS report government may risk investors deciding to invest elsewhere to obtain a tax saving.

5.5.1.4 Fairness and equity

The concept of fairness and equity is based on the premise that similar taxpayers in similar circumstances should be treated in a similar way (Inland Revenue New Zealand, 2017a:9).

The aim is to ensure that taxpayers using branch mismatch arrangements will not obtain an unfair tax benefit when compared to taxpayers who are not able to exploit these opportunities.

Inland Revenue New Zealand (2017) is of the opinion that:

> Unintended tax benefits that are streamed to some taxpayers who are able to take advantage of hybrid mismatches means that a greater tax burden must fall on other taxpayers (such as purely domestic firms) who do not have the hybrid mismatch opportunities that cross border businesses do. Accordingly, introducing rules to counter hybrid mismatch arrangements will restore some fairness to the tax system as those tax burdens will be shared more equally (Inland Revenue New Zealand, 2017a:11).

This will restore some faith in the fairness of the tax system from the viewpoint of purely domestic entities following the extensive media coverage that entities exploiting BEPS such as Google has garnered.

5.5.1.5 Sustainability

It is imperative that the chosen option is sustainable in order to achieve the anticipated results in the long term. The implemented approach should minimise the potential for tax evasion and avoidance while keeping counteracting measures proportionate to the risks involved (Inland Revenue New Zealand, 2017a:9).

In this regard the targeted option as discussed in chapter 5.3.3 will not be viable in the long run as it is expected that taxpayers will restructure arrangements to fall outside the ‘targeted area’. This will require government to continuously identify the structures employed and ensure that legislation targeting these structures is enacted.

5.5.2 OECD proposed implementation and recommendations

The 2015 Hybrid Mismatch Arrangements report sets out further actions that countries should take to ensure that rules are interpreted and applied consistently on a cross-border basis (EY, 2015).

Recommendation 9.2 of the 2015 report includes the following measures to ensure effective implementation of the proposed recommendations (EY, 2015):

- The development of agreed guidance on how the rules should be applied;
- The development of standards that will allow co-ordination of the implementation of the recommendations, including timing in the application of rules, minimizing impact arising from a different implementation time;
- Identifying the need for transitional rules (in this regard the recommendation states that the need for transitional arrangements can be minimised by ensuring a sufficient notice period for taxpayers and that there will be no presumption as to the need for grandfathering rules);
- Reviewing the operation of the rules as necessary to determine whether they are operating as intended;
- Entering into exchange of information, with early and spontaneous exchange of information recognised as key to an effective implementation of hybrid mismatch rules;
- Endeavouring to make relevant information on the tax treatment of entities and financial instruments available to taxpayers;
- Consideration of the interaction with other BEPS Actions.

There are a number of other issues that will also need to be considered based on the specific country looking at implementation, their current domestic laws and the outcomes they are trying to achieve.

Issues specifically to be considered by South Africa will be discussed in chapter 6.5.

5.6 Amendments made by selected countries

The amendments made to the domestic legislation of the selected countries will now be examined in detail.

5.6.1 The United Kingdom

The United Kingdom enacted Part 6A of the TIOPA applicable to payments made from 1 January 2017 onwards.

The chapters included in Part 6A are as follows:

•Chapter 1 Introduction;

•Chapter 2 Key definitions;

•Chapter 3 Hybrid and other mismatches from financial instruments;

•Chapter 4 Hybrid transfer deduction/non-inclusion mismatches;

•Chapter 5 Hybrid payer deduction/non-inclusion mismatches;

•Chapter 6 Deduction/non-inclusion mismatches relating to transfers by permanent establishments;

•Chapter 7 Hybrid payee deduction/non-inclusion mismatches;

•Chapter 8 Multinational payee deduction/non-inclusion mismatches;

•Chapter 9 Hybrid entity double deduction mismatches;

•Chapter 10 Dual territory double deduction cases;

•Chapter 11 Imported mismatches;

•Chapter 12 Adjustments in light of subsequent events et cetera;

•Chapter 13 Anti-avoidance;

•Chapter 14 Interpretation.

The new rules repealed the tax arbitrage rules that were contained in Part 6 of the TIOPA. There is some overlap of the new provisions with the legislation that was previously contained in Part 6 of the TIOPA, but there are also material differences.

According to Wright (2016) the main differences between the new provisions and the previous provisions contained in Part 6 of the TIOPA are:

> there is no 'purpose' based exclusion from the rules. This contrasts with the tax arbitrage rules, under which the so-called 'Condition C' test allows relief from them if arrangements do not have a main purpose of achieving a UK tax advantage for the company. The practical effect of this will be that, for taxpayers relying on Condition C, including cases when HMRC has given a

Condition C clearance, it is likely that the new rules will have an adverse tax impact in the UK; and

the tax arbitrage rules are concerned primarily with hybrid entities and hybrid instruments, whereas the new rules are extended to cover mismatches arising from PEs and dual residents too.

These rules only affect hybrid mismatch arrangements and do not contain any provisions relating to branch mismatch rules. The United Kingdom has not indicated when they will adopt the recommendations relating to branch mismatch arrangements.

The proposed amendments to the legislation were published on 1 December 2017 and were enacted on 14 March 2018 in the Finance Act 2018 which clarifies some areas of ambiguity that arose from the draft legislation. The United Kingdom also published updated guidance on 29 November 2017 in terms of understanding Her Majesty's Revenue and Customs' (HMRC) view of how the rules operate. The guidance relates to the original version of the rules and not the amended version in the Finance Act 2018 (British Private Equity & Venture Capital Association, 2018:23).

5.6.2 New Zealand

The following sections of the Income Tax Act 2007 were amended and/or inserted by the Taxation (Neutralising Base Erosion and Profit Shifting) Act 16 of 2018 with effect from 1 July 2018 (Inland Revenue New Zealand, 2018: 1):

•BH 1(4) - Double tax agreements

•Section EX 44 (2); EX 46 (6) (e); EX 46 (10) (db); EX 47B; EX 52 (14C) and EX 53 (16C) - Calculation of Foreign Investment Fund income or loss

•FE 6 (2); FE 6 (3) (a); FE 6 (3) (aba) and FE 15 (1) (a) - Interest apportionment on thin capitalisation.

•Sections FH 1 to FH 15 - Hybrid and branch mismatches of deductions and income from multi-jurisdictional arrangements.

•RF 2C and RF 11C - Withholding tax on non-resident passive income.

Some of the provisions enacted apply to both hybrid and branch mismatch arrangements. The provisions specifically aimed at branch mismatch arrangements will now be examined in detail.

5.6.2.1 Subpart FH

The new subpart FH inserted in the Income Tax Act 2007 entitled ‘hybrid and branch mismatches of deductions and income from multi-jurisdictional arrangements’ is specifically aimed at the recommendations made by the OECD with certain modifications and variations relevant in the New Zealand context.

The following sections of subpart FH is relevant in addressing branch mismatch arrangements:

- Sections FH 1 and FH2 contain the key concepts and principles;
- Sections FH 5 and FH6 which relate to deemed branch payments;
- Section FH 7 relating to branch payee mismatches;
- Sections FH 8 and FH9 which relate to deductible branch payments resulting in double deductions;
- Section FH 11 relating to imported branch mismatches;
- Section FH 12 providing for the offset of mismatch amounts against surplus assessable income and
- Section FH 15 containing the relevant definitions.

The application of the rules is limited to situations where the transacting parties are related or in situations where the transaction was structured to obtain a branch mismatch. This is in line with the OECD’s recommendations.

5.6.2.1.1 Section FH1

Section FH1 implements the OECD recommendations for domestic law and provides a guide to the background, general scheme and effect of the branch mismatch rules.

The primary rule is broadly that the payer country should deny a deduction for a payment made to the extent it is:

- Not included in the taxable income of the recipient country (for a D/NI mismatch); or
- Claimed with respect to expenditure of a resident that is also deductible in another country (for a DD mismatch) (Inland Revenue New Zealand, 2018: 5).

Section FH1 (3) makes provision for a primary and a defensive rule to be implemented. In a situation where the country or territory in the position to apply the recommended primary rule has not implemented the recommendation, the defensive rule can be applied.

If the primary rule is not applied because the payer country has not implemented the hybrid and branch mismatch rules, then the defensive rule can be applied by:

- requiring the deductible payment to be included in taxable income of the recipient (for a D/NI mismatch); or
- denying the deduction in the country where the payment is made (for a DD mismatch) (Inland Revenue New Zealand, 2018: 6).

5.6.2.1.2 Section FH2

Section FH2 sets out the order of application of the provisions contained in subpart FH2.

Since the both the branch and the residence countries may have implemented branch mismatch rules to adjust the tax outcomes under a particular branch mismatch arrangement, an order of application through 'primary' and 'defensive' rules was determined. This ensures that, in situations where both countries have implemented branch mismatch rules that would counter a particular arrangement, only one country will counter the mismatch (Inland Revenue New Zealand, 2018: 5).

5.6.2.1.3 Section FH5

Section FH5 entitled 'payments by New Zealand resident or New Zealand deducting branch producing deduction without income' relates to deemed branch payments.

Section FH5 (1) states that:

> This section applies when a person or entity **(the payer) incurs an amount of expenditure** in an income year **relating to a payment to another person** and **meeting the requirements of subsection (2)**, **or** incurs in an income year a charge **meeting the requirements of subsection (3)**, and—
>
> (a) the payment or charge is not assessable income of the person who receives the payment or benefits from the charge; and
>
> (b) the amount or charge would be allowed as a deduction in the income year for the payer in the absence of this section and sections FH 7 to FH 11; and
>
> (c) the taxation law of a country or territory outside New Zealand (the payee jurisdiction)—

(i) treats the payment or charge as not being received by a person or entity in the payee jurisdiction, because of the tax status of the payer; and

(ii) would treat the payment or charge as being received by a person or other entity (the payee) in the payee jurisdiction, if the tax status of the payer were different; and

(d) no country or territory outside New Zealand and the payee jurisdiction imposes tax on the payment or charge under taxation law that includes rules corresponding to the CFC rules and recognises the payment as the equivalent of attributed CFC income of a person in the same control group as the payee.

The requirements of subsection (2) are as follows:

> Expenditure relating to a payment by a payer that is a New Zealand resident, or a New Zealand deducting branch of a non-resident, to a payee meets the requirement of this subsection if—
>
> (a) the payee is a non-resident; and
>
> (b) the payment is made under a **structured arrangement** or, when the expenditure is incurred, the payer is in a **control group with the payee or is the same person as the payee.**

The rule will only apply if the payment is made to a related party in the control group or under a structured arrangement. These terms will be investigated when section FH15 is analysed.

Section FH5(3) states that:

> A charge of an amount meets the requirements of this subsection if the amount—
>
> (a) is charged by a non-resident to a New Zealand deducting branch of the non-resident; and
>
> (b) represents amounts, relating to the activities outside New Zealand of the non-resident, allocated to the deducting branch; and
>
> (c) is not determined by reference to the amount of a payment by the non-resident, or a member of the same control group as the non-resident, to a person other than the non-resident and the members of the control group; and
>
> (d) exceeds expenditure or loss, incurred by the non-resident or a member of the same control group as the non-resident, that—
>
> (i) belongs to a category of expenditure or loss equivalent to the category to which the charge belongs; and
>
> (ii) is the reference by which the amount of the charge is determined.

The charges referred to in subsection (3) are only subject to tax to the extent they do not reflect a simple allocation of actual third-party costs. The charges referred to in this subsection would include amounts to which a profit margin was charged by the head office to the branch, or a charge for some internally-performed function (Inland Revenue New Zealand, 2018:35). Section FH5 only applies if the New Zealand branch is the payer deducting the expense.

The mismatch amount per section FH5(4) is the amount of the charge that exceeds the expenditure or loss referred to in subsection (3)(d) if the requirements of subsection 3 are met.

Section FH5 correlates to recommendation 3 of the branch mismatch report as discussed in chapter 4.2.3. Section FH5 is a primary rule and applies with priority over the defensive rules of foreign countries (Inland Revenue New Zealand, 2018: 35). The rule is thus of concern to New Zealand branches of non-residents that incur a charge relating to deemed branch payments.

Where the relevant requirements and conditions of section FH5 are met, the payer of the payment is denied a deduction for the charge (including foreign exchange gains and losses) relating to the payment, under subsection (4). Section FH 12 provides that if the payer has surplus assessable income the mismatch amount may be set off against that amount.

5.6.2.1.4 Section FH6

Section FH6 entitled ‘receipts from foreign deducting branch producing deduction without income’ also relates to deemed branch payments.

Section FH6(1) states that:

> This section applies when a non-resident, or **foreign deducting branch of a New Zealand resident, (the payer) is treated by the taxation law of a country or territory outside New Zealand (the payer jurisdiction) as making a payment in an income year to a person or other entity (the payee) in New Zealand** and **meeting the requirements of subsection (2), or** incurring a charge in the income year **meeting the requirements of subsection (3),** and—
>
> (a) the payment or charge would not give rise to assessable income of the payee in the income year in the absence of this section; and
>
> (b) the payer jurisdiction allows the payer or other person or entity to deduct an amount of the payment or charge against income or allows an equivalent tax relief for the payment; and
>
> (c) the payer jurisdiction does not have hybrid mismatch legislation corresponding to section FH 5 that applies to the payment or charge and to the payer at any time in the income year; and
>
> (d) the payment or charge would give rise to assessable income of the payee in the income year if the payer and payee were persons and separate or if the tax status of the payer were different.

Section FH 6 thus applies where New Zealand is not including a payment (or deemed payment) as income and the payment (or deemed payment) is deductible in another country, assuming all the relevant requirements are met.

The requirements of subsection (2) are as follows:

> Expenditure relating to a payment by a payer that is not a New Zealand resident, or is a foreign deducting branch of a New Zealand resident, to a payee meets the requirement of this subsection if—
>
> (a) the payee is a New Zealand resident; and
>
> (b) the payment is made under a structured arrangement or, when the expenditure is incurred, the payer is in a control group with the payee or is the same person as the payee.

The rule will only apply if the payment is made to a related party in the control group or under a structured arrangement. The requirements of section FH6(2) is thus similar to those of section FH5(1), which will be defined during the analysis of Section FH15.

Section FH6(3) states that:

> For the purposes of subsection (1), the amount of a charge treated by the payer jurisdiction as being required by a New Zealand resident from a foreign deducting branch of the New Zealand resident is equal to the amount that—
>
> (a) represents amounts, relating to the activities of the New Zealand resident in New Zealand, allocated to the deducting branch; and
>
> (b) is not determined by reference to the amount of a payment by the New Zealand resident, or a member of the same control group as the New Zealand resident, to a person other than the New Zealand resident and the members of the control group; and
>
> c) exceeds expenditure or loss incurred by the New Zealand resident, or a member of the same control group as the New Zealand resident, that—
>
> (i) belongs to a category of expenditure or loss equivalent to the category to which the charge belongs; and
>
> (ii) is the reference by which the amount of the charge is determined.

These requirements are again similar to those as per section FH5(3). The purpose of these requirements is that section FH 6 should only apply to a mismatch arising because of an intra-group charge deduction in a foreign country being unmatched by income in New Zealand (Inland Revenue New Zealand, 2018:38).

The mismatch arising from the transactions mentioned in this subsection is referred to as assessable income per section FH6(4). Section FH6(4) provides that the payee derives assessable income from the payment or charge equal to the greater of zero and the amount that would be assessable income of the payee, if the payer and payee were persons and separate or if the tax status of the payer were different.

The mismatch amount under subsection (6) can be reversed if the taxpayer has surplus assessable income under section FH 12 to offset against it (Inland Revenue New Zealand, 2018:38).

Section FH6 correlates to recommendation 3 of the branch mismatch report as discussed in chapter 4.2.3. Section FH6 is the defensive rule for recommendation 3 report, even though the report does not recommend a defensive rule (Inland Revenue New Zealand, 2018: 37). The defensive rule mirrors the primary rule and is thus of concern to foreign deducting branches of a New Zealand residents that incur a charge relating to deemed branch payments.

Where the relevant requirements and conditions of section FH6 are met the amount of the payment or charge is deemed to be assessable income under subsection (4).

Subsection (7) prevents a mismatch amount under subsection (5) from being carried forward if the payer country introduces hybrid mismatch legislation corresponding to the primary rule for deemed branch payment mismatches (Inland Revenue New Zealand, 2018: 38).

5.6.2.1.5 Section FH7

Section FH7 entitled ‘payments to persons outside New Zealand producing deduction without income’ relates to diverted and disregarded branch payments.

Section FH7(1) states that:

> This section applies when a person (the payer) incurs an amount of expenditure (the incurred amount) in an income year relating to an amount of a payment to a person (the payee) that exists under the law of a country or territory outside New Zealand (the payee jurisdiction) and—
>
> (a) the incurred amount would be allowed as a deduction for the payer in the absence of this section and sections FH 8 to FH 11; and
>
> (b) under the taxation law of the payee jurisdiction, the amount is treated as being—
>
> (i) received in a country or territory outside the payee jurisdiction:
>
> (ii) income of a person who is in the same control group as the payer; and
>
> (c) the payment is made under a structured arrangement or the payer is in the same control group as the payee when the expenditure is incurred; and
>
> (d) under the taxation law of the countries and territories outside New Zealand, the amount received by the payee is not subject to taxation as income and is not recognised as CFC attributed income, or the equivalent of attributed CFC income, of a person in the same control group as the payee; and
>
> (e) an equivalent payment by the payer would have been subject to taxation—
>
> (i) as income of the payee, under the taxation law of the payee jurisdiction if the equivalent payment were treated as being received by the payee in the payee jurisdiction:
>
> (ii) as income of a person who is in the same control group as the payer, under the taxation law of a country or territory, outside New Zealand and the payee jurisdiction, if

> the equivalent payment were treated as being received by the person in that country or territory.

Section FH7 thus applies when a New Zealand resident entity makes a deductible payment to the foreign branch of a group member and the payee country deems the payment to either be a diverted or disregarded branch payment. Diverted and disregarded branch payments were discussed in detail in chapter 3.5.1 and 3.5.2. This results in a deductible payment not resulting in income recognition by any of the counterparties.

Section FH7(1) refers to the payee as a person that exists under the law of a country or territory outside New Zealand. This requirement assumes that the person is not a natural person, and owes their existence to the laws of a particular country (Inland Revenue New Zealand, 2018: 41).

Section FH7(2) determines the amount of the deduction to be denied. In terms of this subsection the payer is denied a deduction for the incurred amount and, if the payment is made under a financial instrument denominated in the currency of a country or territory other than New Zealand, any related expenditure from foreign currency movements (Inland Revenue New Zealand, 2018: 42).

Section FH7 correlates to recommendation 2 of the branch mismatch report as discussed in chapter 4.2.2. Section FH7 is a primary rule, no defensive rule was recommended by the OECD or implemented by New Zealand. The rule is thus of concern to New Zealand residents making a deductible payment which is not included in the income of a related party due to diverted or disregarded branch mismatches.

Section FH7(1)(c) includes the same proviso as section FH5 and that the payment has to be made to a related party in the control group or under a structured arrangement.

Section FH7(1)(e) contains a counterfactual requirement in that the payment would have been subject to income tax in the head office jurisdiction (payee jurisdiction) had it been treated as a payment to the head office in the payee jurisdiction.

Section FH7 does not have a provision similar to sections FH5 and FH6 allowing a set off against surplus assessable income in terms of section FH12.

5.6.2.1.6 Section FH8

Section FH8 entitled ‘Expenditure or loss through hybrid entity or foreign deducting branch producing double deduction without double income’ relates to double deductions.

Section FH8(1) states that:

> This section applies for a New Zealand resident and an income year when the New Zealand resident is related to a hybrid entity existing under the law of a country or territory outside New Zealand, or has a deducting branch in such a country or territory, and—
>
> (a) the taxation law of the country or territory allows expenditure or loss of the hybrid entity, or of the New Zealand resident attributed to the deducting branch, in the income year to be set off against income of another person or entity; and
>
> (b) the income of the other person or entity, other than from a source in New Zealand, is not assessable income.

Section FH8 thus applies when a New Zealand resident entity is able to deduct an amount which is also deductible by the foreign branch, thus resulting in a double deduction. Double deductions branch payments were discussed in detail in chapter 3.5.4.

The rule contains a restriction in its application. The scope of the rule is limited to foreign branches that are capable of offsetting their losses against the income of an existing foreign entity, thus forming a tax group. The section thus only applies if the relevant foreign country allows losses of the branch to be offset against income of an existing person whose income is not taxed in New Zealand, other than that which is sourced in New Zealand (Inland Revenue New Zealand, 2018: 44).

Section FH8(2) provides that the New Zealand resident is denied a deduction for the amount of expenditure or loss incurred that is attributed to the deducting branch and would, in the absence of this section and sections FH9 and FH10, be allowed as a deduction.

Section FH8 correlates to recommendation 4 of the branch mismatch report as discussed in chapter 4.2.4. Section FH8 is a primary rule and applies with priority over the defensive rules of foreign countries (Inland Revenue New Zealand, 2018: 44).

This expenditure is treated as a mismatch amount that can be offset (that is, deducted) to the extent there is surplus assessable income under section FH12 in terms of subsection FH8(3).

Subsection FH8(4) contains transitional provisions to cater for situations where a person that fell outside the scope of section FH8(1) subsequently falls within the scope of section FH8(1). This could be as a result of to a change in the group structure. The rule applies prospectively for persons in such a situation to reverse their historic foreign branch losses if they become usable in the other country in a way that would defeat the integrity of the primary rule (Inland Revenue New Zealand, 2018: 47).

The transitional rule will only apply if:

• the person was related to a foreign hybrid entity or had a foreign branch prior to subsection (1) applying to the person; and

• the laws of the relevant foreign country allow accumulated losses of the hybrid entity or branch to be set off against income that is not assessable in New Zealand under the new structure (Inland Revenue New Zealand, 2018: 47).

To the extent those requirements are met, section FH8(5) treats the net loss of the hybrid entity or branch as assessable income which represents a mismatch amount.

5.6.2.1.7 Section FH9

Section FH9 entitled 'Expenditure or loss of hybrid entity, or non-resident through deducting branch, producing double deduction without double income' relates to double deductions.

Section FH9(1) states that:

> This section applies **when a resident (the foreign resident) in a country or territory outside New Zealand (the foreign jurisdiction)** is in the same control group as a hybrid entity resident in New Zealand, or **has a deducting branch in New Zealand**, if—
>
> (a) expenditure or loss of the hybrid entity, or of the foreign resident attributed to the deducting branch, would be allowed as a deduction in an income year in the absence of this section and section FH 10; and
>
> (b) the taxation law of a country or territory outside New Zealand allows expenditure of the hybrid entity or attributed to the deducting branch to be deducted in the income year against income of the foreign resident; and
>
> (c) the foreign jurisdiction does not have hybrid mismatch legislation corresponding to section FH 8 and applying at any time in the income year to expenditure of the hybrid entity or foreign resident referred to in paragraph (b).

Section FH9 thus applies to a foreign resident operating in New Zealand through a branch when expenditure of the branch is deductible in New Zealand and the country of the foreign resident also allows that expenditure as a deduction for the foreign resident. Double deductions branch payments were discussed in detail in chapter 3.5.4. The rule does not apply where the country of that foreign resident has enacted hybrid mismatch legislation corresponding to the primary rule (Inland Revenue New Zealand, 2018: 48).

Section FH9(2) denies a deduction for the expenditure incurred in New Zealand, and section FH9(3) treats the denied deduction as a mismatch amount unless and until it is set off against surplus assessable income under section FH12 (Inland Revenue New Zealand, 2018: 48).

Section FH9 correlates to recommendation 4 of the branch mismatch report as discussed in chapter 4.2.4. Section FH9 is a defensive rule and mirrors the primary rule. The defensive rule only applies if the foreign resident country has not enacted branch mismatch legislation corresponding to the primary rule (Inland Revenue New Zealand, 2018: 48).

5.6.2.1.8 Section FH11

Section FH11 entitled 'Residents, or non-residents with deducting branches, having expenditure funding overseas hybrid mismatches' relates to imported branch mismatches.

Section FH11(1) states that:

> This section applies for a New Zealand resident, or **a non-resident with a deducting branch in New Zealand (the funder)**, and an income year **when the funder makes a payment to a person in a country or territory outside New Zealand that does not have hybrid mismatch legislation** corresponding to this subpart and—
>
> (a) the payment provides funds, directly or indirectly, for a payment (the funded payment) from a person or other entity (the payer) in a country or territory outside New Zealand (the payer jurisdiction) to a person or other entity (the payee), in the same or another country or territory outside New Zealand (the payee jurisdiction); and
>
> (b) the expenditure on the payment would be allowed as a deduction for the funder in the absence of this section and sections FH 8 to FH 10; and
>
> (c) the payment is made under a structured arrangement giving rise to the hybrid mismatch referred to in paragraph (d) or the funder and the payer, when the expenditure is incurred, are members of a control group; and
>
> (d) the funded payment gives rise to a hybrid mismatch; and
>
> (e) the payer jurisdiction and the payee jurisdiction do not have hybrid mismatch legislation that counteracts the hybrid mismatch.

Section FH11 thus applies to a foreign resident operating in New Zealand through a branch when expenditure of the branch is seen to be funding another payment which does give rise to a branch mismatch. Imported mismatches were discussed in detail in chapter 3.5.5. The imported mismatch thus occurs when a payment that does not directly result in a branch mismatch outcome funds another payment that does result in a branch mismatch outcome (Inland Revenue New Zealand, 2018: 51).

In terms of subsection F11(2) the funder can be denied a deduction if the payment is made under a structured arrangement or if the payment is made for other unstructured imported mismatches.

The amount denied for payment under structured arrangement is determined under subsection FH11(3) as follows:

> The amount of the denial is the lesser of—
>
> (a) the amount of the deduction that would be allowed for the payment in the absence of this section and sections FH8 to FH10:
>
> (b) the amount of the funded payment that, if hybrid mismatch legislation were applied by the payer jurisdiction, would be disallowed as a deduction against income or equivalent tax relief.

The amount denied for other payments not made under a structured arrangement is determined under subsection FH11(4) as follows:

> Under this subsection, the amount of the denial is the amount of the payment
>
> that can fairly and reasonably be treated as providing funds for the funded payment.

Section FH11(3), is applicable to payments made under a structured arrangement in income years beginning on or after 1 July 2018. Deductions for other imported mismatch payments (unstructured imported mismatches) are not denied until income years beginning on or after 1 January 2020 (Inland Revenue New Zealand, 2018: 52).

The purpose of imported mismatch rule is to prevent taxpayers from entering into structured arrangements or arrangements with group members that shift the effect of an offshore hybrid mismatch into New Zealand through the use of a non-hybrid instrument such as an ordinary loan (Inland Revenue New Zealand, 2018: 52).

Subsection FH11(5) provides that the amount described in subsection (4) should be determined consistently with the approach described in chapter 8 of the hybrid mismatch report.

Section FH11 correlates to recommendation 5 of the branch mismatch report as discussed in chapter 4.2.5.

5.6.2.1.9 Section FH12

Section FH12 entitled 'Offset of mismatch amounts against surplus assessable income' relates to the offset of branch mismatches.

Section FH12(1) states that:

> This section applies when a person has a mismatch amount under sections FH 5, FH 6, and FH 8 to FH 10 from a mismatch situation for an income year.

Subsection FH12(2) provides for the total of mismatch amounts from the mismatch situation for the income year to be set off against the person's total surplus assessable income from the mismatch situation in terms of subsection (3).

Subsection FH12(3) defines surplus assessable income as:

> The person has an amount of surplus assessable income, for the mismatch situation and the income year, equal to the greater of zero and the amount calculated using the formula—
>
> earlier + assessable + exempt − unrecognised − protected − deductions + status.

Each of the above terms per the formula is defined in subsection FH12(4):

> (a) *earlier* is the amount of surplus assessable income for the person from the mismatch situation carried forward to the tax year corresponding to the income year from earlier tax years:
>
> (b) *assessable* is the amount of assessable income derived from the mismatch situation by the person in the income year:
>
> (c) *exempt* is zero, except for a person that is a hybrid entity resident in New Zealand and owned by a non-resident, for which it is the amount of income of the hybrid entity that—
>
> (i) is exempt income under section CW 10 (Dividend within New Zealand wholly-owned group); and
>
> (ii) for an owner of the hybrid entity, is income subject to tax under the taxation law of another country or territory without a credit for tax, other than a withholding tax on the dividend, paid by the person paying the dividend:
>
> (d) *unrecognised* is the amount of the assessable income of the person from the mismatch situation for the income year that is not subject to tax under the taxation law of the foreign jurisdiction because of the residence of another person, who is not another owner, or because of the source of the income:
>
> (e) *protected* is the amount of taxable income for which the income tax liability of the person would equal foreign tax credits under subpart LJ (Tax credits for foreign income tax) allowed for the assessable income from the mismatch situation for the income year:

(f) *deductions* is the amount of deductions allowed for expenditure incurred by the person in the income year in deriving assessable income from the mismatch situation, not including expenditure giving rise to mismatch amounts:

(g) *status* is the amount of expenditure on a payment by the person to a payee in New Zealand that is a mismatch amount under section FH 9 and that is not allowed to be deducted against income by the tax law of a country or territory outside New Zealand because of the tax status of the person and the payee.

Section FH12 relates to the OECD concept of 'dual inclusion income'. In this Act it is referred to as surplus assessable income. An important point emphasised throughout the OECD branch report is that a mismatch will not occur if payments are deducted against dual inclusion income as no double non-taxation and therefore no tax mischief occurs (Inland Revenue New Zealand, 2018: 59).

The purpose of section FH12 is to reverse the denial of deductions (or inclusion of income, in the case of section FH6, that arises under sections FH5, FH6 and FH8 to FH10 where there is surplus assessable income. In terms of subsection FH12(5) the surplus assessable income can arise in a different income year from the year the branch mismatch is disallowed (Inland Revenue New Zealand, 2018: 59).

Both the mismatch amount and surplus assessable income for the income year can be carried forward in terms of subsections FH12(6) and (7). Subsection (7)(a) reduces the amount of surplus assessable income by the amount that is subject to the foreign tax credit regime of a foreign country equivalent to New Zealand's subpart LJ . This ensures that the net New Zealand income from a mismatch situation cannot be offset against future mismatch amounts if double tax has been relieved by a foreign country through foreign tax credits in relation to that net New Zealand income (Inland Revenue New Zealand, 2018:63). The carry forward is subject to the provisions per subsection (8).

Subsection (9) applies in a situation where an amount for which a deduction is denied under section FH8 (a double deduction amount) ceases to be a mismatch amount. This may be due to the person having the loss in the other country ceasing to exist before the loss is used in the other country. Therefore, the loss is no longer able to be used in that other country and is referred to as a 'stranded loss' (Inland Revenue New Zealand, 2018:63).

Subsection (10) contains a provision allowing the mismatch amount to be offset against surplus assessable income of a group company if:

(a) the companies are in the same wholly-owned group when the mismatch amount and the surplus assessable income arise; and

(b) the mismatch amount and the surplus assessable income are available after each of the companies has all offsets permitted for the income year of amounts arising from the mismatch situation in which the company is involved; and

(c) the offset would be permitted if the offset company were substituted for the group company in the income situation.

Section FH12 applies separately to each mismatch situation to which a person is party, but it applies to all mismatch amounts with respect to that situation (Inland Revenue New Zealand, 2018: 59).

It is important to note that unlike the OECD's dual inclusion income, surplus assessable income does not depend on the actual assessable amounts in each country (Inland Revenue New Zealand, 2018: 60).

5.6.2.1.10 Section FH15

Section FH15 contains the definitions applicable to subpart FH.

The following definitions are relevant when dealing with the provision relating to branch mismatch arrangements.

control group

means a group of persons in which, for each member and each other member,—

(a) the members are—

(i) consolidated, or required to be consolidated, for accounting purposes:

(ii) members of a group of companies for which an applicable financial reporting standard requires the preparation of group financial statements for an accounting period:

(b) the members are companies that are associated under section YB 2 (Two companies):

(c) 1 of the members is a company and the other person has, or is a member of a group of persons acting together that has,—

(i) a voting interest in the company of 50% or more, applying the general aggregation rule in section YB 3(3):

(ii) if a market value circumstance exists for the company, a market value interest in the company of 50% or more, applying the general aggregation rule in section YB 3(3):

(d) the members are associated under section YB 4 (Two relatives):

(e) the members are associated under sections YB 5 to YB 11 (which relate to a trustee or settlor of a trust):

(f) 1 of the members is a partnership, or is a limited partnership, and the other member,—

(i) if the partnership is a limited partnership, is a general partner or is a limited partner that has a partnership share of more than 50% in a right, obligation, or other property, status, or thing of the limited partnership, applying the general aggregation rule in section YB 12(3) (Partnership and partner):

(ii) if the partnership is not a limited partnership, is a partner that has a partnership share of more than 50% in a right, obligation, or other property, status, or thing of the partnership, applying the general aggregation rule in section YB 12(3):

(g) 1 of the members, or a group consisting of 1 of the members and persons that are related to or act together with that member, effectively controls the other member:

(h) a person or group of persons, together with persons who are related to or act together with the person or a person in the group, effectively controls each of the 2 members

deducting branch,

for a person, means a branch, permanent establishment, or other activity, of the person in a country or territory, such that expenditure or loss attributed by the person to the branch, permanent establishment, or activity is recognised by the tax law of the country or territory as giving rise to a deduction against income of the person or other tax relief

structured arrangement,

for a person, means an arrangement to which the person or a member of the person's control group is a party—

(a) for which—

(i) a transaction under or involving the arrangement has a price that assumes the existence of a hybrid mismatch:

(ii) the facts or circumstances indicate that the arrangement is intended to rely on or produce a hybrid mismatch; and

(b) under which the person, or a member of the person's control group, can reasonably be expected to be aware of—

(i) a tax benefit for the person that arises from the hybrid mismatch:

(ii) the existence of the hybrid mismatch

surplus assessable income,

means an amount, arising from a mismatch situation and determined under section FH 12, against which a mismatch amount from the mismatch situation may be set off under section FH 12.

New Zealand did not enact any provisions to limit the scope of the branch exemption as provided in recommendation 1 of the OECD branch report.

The rules are structured in such a manner that taxpayers who have simple foreign branch structures that do not present a hybrid mismatch problem are not covered by the rules (Inland Revenue New Zealand, 2017b).

5.6.3 Australia

Division 832 of the Income Tax Assessment Act 1997 was inserted by Part 1 of the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018 with effect from 1 January 2019.

Division 832 contains the following subdivisions:

• 832-A Preliminary;

• 832-B Concepts relating to mismatches;

• 832-C Hybrid financial instrument mismatch;

• 832-D Hybrid payer mismatch;

• 832-E Reverse hybrid mismatch;

• 832-F Branch hybrid mismatch;

• 832-G Deducting hybrid mismatch;

• 832-H Imported hybrid mismatch;

• 832-I Dual inclusion income;

• 832-J Integrity rule;

• 832-K Modifications for Division 230 (about taxation of financial arrangements).

Part 2 of the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018 amends the Income Tax Assessment Act 1936 to implement part of the OECD branch mismatch rules by limiting the scope of the exemption for foreign branch income and preventing a deduction from arising for payments made by an Australian branch of a foreign bank to its head office in some circumstances (Australian Government Treasury, 2018:4).

Some of the provisions enacted apply only to hybrid mismatch arrangements. The provisions specifically aimed at branch mismatch arrangements will now be examined.

5.6.3.1 Subdivision 832-B—Concepts relating to mismatches

Subdivision 832-B sets out rules about identifying deduction/non-inclusion mismatches and defines key terms.

5.6.3.1.1 Section 832-105

Section 832-105 defines the concept of deduction\non-inclusion mismatch and the term 'deduction component'.

Section 832-105(1) relates to Australian deductions and states:

> If:
>
> (a) a deduction (other than a deduction that is solely attributable to a currency exchange rate effect) is allowable to an entity in an income year in respect of a payment (including a part or share of the payment); and
>
> (b) the amount of the deduction exceeds the sum of the amounts of the payment that are:
>
> (i) subject to foreign income tax in a foreign country in a foreign tax period that starts no later than 12 months after the end of the income year; or
>
> (ii) subject to Australian income tax for the income year;
>
> then the deduction is the deduction component of a deduction/non-inclusion mismatch to which the payment gives rise.

This subsection links to the OECD concept of dual inclusion income. If a payment made by an Australian entity that qualifies as a deduction for that entity exceeds the amounts of the payment included in taxable income in either a foreign country, within 12 months after the end of the tax year of the Australian entity making the payment, or an Australian entity in that same tax year, a mismatch arises. The deduction amount for the Australian entity is then referred to as the deduction component.

Section 832-105(2) relates to foreign income tax deductions and states:

> If:
>
> (a) an entity is entitled to a foreign income tax deduction in a foreign country in a foreign tax period in respect of a payment (including a part or share of the payment); and
>
> (b) the amount of the foreign income tax deduction exceeds the sum of the amounts of the payment that are:
>
> (i) subject to foreign income tax in a foreign country in a foreign tax period that starts no later than 12 months after the end of the foreign tax period in which the foreign income tax deduction arose; or
>
> (ii) subject to Australian income tax for an income year that starts no later than 12 months after the end of the foreign tax period in which the foreign income tax deduction arose; and
>
> (c) the foreign income tax deduction is not solely attributable to:
>
> (i) any currency exchange rate fluctuations; or
>
> (ii) a difference between an expressly or implicitly agreed currency exchange rate for a future date or time and the applicable currency exchange rate at that date or time;

> then the foreign income tax deduction is the deduction component of a deduction/non-inclusion mismatch to which the payment gives rise.

This subsection again links to the OECD concept of dual inclusion income. If a payment made by a foreign entity that qualifies as a deduction for that entity exceeds the amounts of the payment included in taxable income in either a foreign country or an Australian entity within 12 months after the end of the tax year of the Australian entity making the payment, a mismatch arises. This subsection contains a further requirement that the deduction should not arise from currency exchange rate fluctuations. The deduction amount for the foreign entity is then referred to as the deduction component.

The term foreign income tax deduction will be examined in chapter 5.6.3.1.2.

Section 832-105 (3) defines the mismatch amount as:

> The amount of the deduction/non-inclusion mismatch is the amount of the excess worked out under paragraph (1) (b) or (2) (b), as applicable.

The mismatch amount is thus the excess of the deduction over the payments included in taxable income.

5.6.3.1.2 Section 832-120

Section 832-120 defines the concept of 'foreign income tax deduction'.

Section 832-120(1) defines foreign income tax deduction as:

> An amount of a loss or outgoing is a foreign income tax deduction in a foreign country in a foreign tax period to which an entity is entitled, if the entity is entitled to deduct the amount in working out its tax base for the foreign tax period under a law of the foreign country dealing with foreign income tax (except credit absorption tax, unitary tax or a withholding-type tax).

The word 'outgoing' refers to expenses incurred. A foreign income tax deduction is thus an expense or loss qualifying for deduction in terms of the law of the foreign country.

5.6.3.2 Subdivision 832-F—Branch hybrid mismatch

Subdivision 832-F deals exclusively with branch mismatch arrangements. The main purpose of subdivision 832-F is to deny the application of Australia's foreign branch exemption to branch income that is not subject to tax in the foreign jurisdiction, and deductions for deemed intra-branch payments from the Australian branch of a foreign bank where there is no corresponding income in the other jurisdiction (BDO, 2018).

The following provisions are contained with this subdivision of the Act:

• 832-450 What this Subdivision is about;

• 832-455 Deduction not allowable;

• 832-460 Exception where entity not a party to the structured arrangement;

• 832-465 When a branch hybrid mismatch is an offshore hybrid mismatch;

• 832-470 Branch hybrid mismatch;

• 832-475 Hybrid mismatch

• 832-480 Hybrid requirement—payment made directly or indirectly to a branch hybrid;

• 832-485 Branch hybrid.

5.6.3.2.1 Section 832-450

Section 832-450 is the preamble of subdivision 832- F. The aim of subdivision 832-F is to neutralise a branch hybrid mismatch if it involves a deduction in Australia and the non-inclusion was not also in Australia.

Section 832-450 defines a deduction/non-inclusion mismatch as:

> a branch hybrid mismatch made directly or indirectly to a branch hybrid, and the mismatch would not have arisen, or would have been less, if the residence country had not recognised the permanent establishment.

Section 832-450 further states that:

> An entity is a branch hybrid in relation to a payment made to it if, for the purposes of the tax law of the country in which it is a resident, the payment is treated as being allocated to a permanent establishment in another country, but in the other country, the payment is treated as not being allocated to a permanent establishment in that country.

The determination of a branch's PE status is thus an important aspect in determining whether the provisions of subdivision 832-F will apply. A branch hybrid per section 832-450 refers to a disregarded branch as discussed under Chapter 3.3.

The branch hybrid mismatch rules effectively implement recommendation 2 of the OECD Branch Mismatch Arrangements Report.

5.6.3.2.2 Section 832-455

Section 832-455 entitled ‘Deduction not allowable’ defines the amount of the deduction that will not be allowable.

Subsection (2) states that:

> So much of the deduction as does not exceed the amount of the branch hybrid mismatch is not allowable as a deduction.

Subsection (2) limits the disallowance to the amount of the branch hybrid mismatch which is defined in section 832-485.

Subsection (3) provides that the provisions of section 832-455 do not apply if subsection 23AH(4A) of the Income Tax Assessment Act applies. Subsection 23AH will be discussed in detail below. The section deals with branch exemption provided under subsection 23AH(2). Subsection (4A) neutralises the mismatch due to branch exemption by the inclusion of an amount in assessable income for Australian income tax purposes. Section 23AH(4A) thus overrides the application of section 832-44.

5.6.3.2.3 Section 832-460

Section 832-460 entitled ‘Exception where entity not a party to the structured arrangement’ provides for certain circumstances in which the deduction will not be disallowed.

The conditions for the application of the exception per section 832-460 are as follows:

- the entity was not a party to the structured arrangement under which the payment was made and;
- the entity that made the payment and the branch are not in the same control group.

This section effectively limits the application of the rules to payments made to a related party in the control group or if the payment was made under a structured arrangement as envisaged by the OECD in their branch mismatch report.

5.6.3.2.4 Section 832-465

Section 832-465 entitled ‘When a branch hybrid mismatch is an offshore hybrid mismatch’ deals with offshore hybrid mismatches.

A branch hybrid mismatch is an offshore hybrid mismatch per subsection (1) if:

> (a) the deduction component of the mismatch is a foreign income tax deduction; and
>
> (b) the country in which the foreign income tax deduction arose does not have foreign hybrid mismatch rules; and
>
> (c) subsection 23AH(4A) of the Income Tax Assessment Act 1936 does not apply in relation to the branch hybrid mismatch.

The meanings of the above terms were discussed in Chapters 5.6.3.1.1 and 5.6.3.1.2. An offshore hybrid mismatch is thus a deduction\non-inclusion mismatch arising from a deductible foreign expense incurred in a foreign country that does not have foreign hybrid mismatch rules and Section 23AH(4A) that neutralises the mismatch due to branch exemption by the inclusion of an amount in assessable income for Australian income tax purposes could not be applied.

5.6.3.2.5 Section 832-470

Section 832-470 entitled 'Branch hybrid mismatch' deals with the concept of what a branch hybrid mismatch is.

Subsection (1) states that:

> A payment gives rise to a branch hybrid mismatch if:
>
> (a) the payment gives rise to a hybrid mismatch under section 832-475; and
>
> (b) subsection (3) or (4) applies.

The concept of a hybrid mismatch will be discussed below in chapter 5.6.3.2.6.

Subsection (3) refers to a control group and subsection (4) to structured arrangements.

A payment thus gives rise to a branch hybrid mismatch under section 832-470 if the payment is a hybrid mismatch as defined and if the payment was made to a related party in the control group or under a structured arrangement.

5.6.3.2.6 Section 832-475

Section 832-475 entitled 'Hybrid mismatch' deals with the concept of what a hybrid mismatch is.

Subsection (1) states that:

> A payment gives rise to a hybrid mismatch if:
>
> (a) the payment gives rise to a deduction/non-inclusion mismatch; and
>
> (b) the mismatch, or a part of the mismatch, meets the hybrid requirement in section 832-480.

The hybrid requirement will be discussed below in chapter 5.6.3.2.7.

Subsection (2) determines the amount of the hybrid mismatch as follows:

> The amount of the hybrid mismatch is the lesser of: (a) the amount of the deduction/non-inclusion mismatch; and
>
> (b) if there is an excess under either subparagraph 832-480(2)(b)(i) or (3)(b)(i)—the amount of the excess.

The amount of the deduction/non-inclusion mismatch is determined as per the discussion in chapter 5.6.3.1.1.

Subsection (3) contains a rule pertaining to the order of application. Should the mismatch result from a hybrid financial instrument mismatch, a hybrid payer mismatch or a reverse hybrid mismatch, the mismatch should be treated in terms of the provisions of those sections and subdivision 832-F will not apply.

5.6.3.2.7 Section 832-480

Section 832-480 entitled 'Hybrid requirement—payment made directly or indirectly to a branch hybrid' deals with qualifying requirements.

Subsection (1) states that:

> The payment meets the hybrid requirement in this section if:
>
> (a) the payment is made directly, or indirectly through one or more interposed entities, to a branch hybrid; and
>
> (b) subsection (2) or (3) applies.

Subsection (2) deals with payments that would have been taxed in Australia and applies if:

> (a) the residence country identified in subsection 832-485(2) is Australia; and
>
> (b) either:
>
> > (i) the amount of the deduction/non-inclusion mismatch exceeds the amount that would be the amount of that mismatch if the amount of the payment that was subject to Australian income tax for an income year was instead worked out on the assumption in subsection (4); or

(ii) on the assumption in subsection (4), the payment would have given rise to a hybrid financial instrument mismatch or a hybrid payer mismatch.

Subsection (3) deals with payments that would have been taxed in a foreign country and applies if:

(a) the residence country identified in subsection 832-485(2) is a foreign country; and

(b) either:

(i) the amount of the deduction/non-inclusion mismatch exceeds the amount that would be the amount of that mismatch if the amount of the payment that was subject to foreign income tax for a foreign tax period was instead worked out on the assumption in subsection (4); or

(ii) on the assumption in subsection (4), the payment would have given rise to a hybrid financial instrument mismatch or a hybrid payer mismatch.

The assumption in subsection (4) refers to the following:

For the purposes of subsections (2) and (3), assume that the payment was instead treated as income derived by the liable entity but not in carrying on a business at or through a PE in another country for the purposes of:

(a) if the residence country is Australia—this Act; or

(b) if the residence country is a foreign country—the law of the residence country relating to foreign income tax (except credit absorption tax, unitary tax or a withholding-type tax).

A payment will meet the hybrid requirement if the payment is made directly or indirectly through one or more interposed entities to a branch hybrid and the amount of the deduction/non-inclusion mismatch exceeds the amount that would have been taxable if the branch was not carrying on a business at or through a PE in another country.

5.6.3.2.8 Section 832-485

Section 832-485 entitled 'Branch hybrid' determines when an entity is a branch hybrid.

Subsection (1) states that:

An entity is a branch hybrid, in relation to a payment made to the entity, if:

(a) subsection (2) applies to the entity in relation to a country and a payment; and

(b) subsection (4) applies to the entity in relation to the payment.

Subsection (2) deals with a payment made to a resident in a residence country that applies branch profits exemption and applies if:

(a) the entity satisfies the residency test in subsection 832-555(9) and is a liable entity in respect of its own income or profits; and

(b) the payment is treated as income derived by the liable entity in carrying on a business at or through a PE in another country; and

(c) as a result of an exemption or other tax concession to which that liable entity is entitled in respect of income derived in carrying on a business at or through the PE, the payment is not:

(i) if the residence country is Australia—subject to Australian income tax; or

(ii) if the residence country is a foreign country—subject to foreign income tax in that foreign country.

Subsection (4) deals with a situation where the branch country fails to tax the payment and applies if:

(a) the payment is treated as not having been derived in carrying on a business at or through a PE of the entity, or as otherwise not having a sufficient connection to a taxable presence in the branch country, for the purposes of:

(i) if the branch country is Australia—this Act; or

(ii) if the branch country is a foreign country—the law of the branch country relating to foreign income tax (except credit absorption tax, unitary tax or a withholding-type tax); and

(b) as a result, the payment is not:

(i) if the branch country is Australia—subject to Australian income tax; or

(ii) if the branch country is a foreign country—subject to foreign income tax in that foreign country.

Subsection (5) modifies the meaning of PE specifically for a branch mismatch as follows:

(a) the residence country has entered into, with the branch country:

(i) if either the residence country or the branch country is Australia—an international tax agreement; or

(ii) if subparagraph (i) does not apply—a treaty or other agreement relating to the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital; and

(b) the agreement or treaty (as the case requires) contains:

(i) if either the residence country or the branch country is Australia—a permanent establishment article; or

(ii) if subparagraph (i) does not apply—a provision 1 corresponding to a permanent establishment article.

Subsection (6) provides that:

A reference in this section to a PE in a country is taken to be a reference to a permanent establishment within the meaning of the relevant agreement or treaty in the country.

5.6.3.3 Section 23HA of the Income Tax Assessment Act 1936

Section 23HA entitled 'Foreign branch income of Australian companies not assessable' provides a branch exemption when an active foreign branch is deriving income in a foreign country. This section was amended by Part 2 of the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018 to bring the provision in line with recommendation 1 of the OECD branch report discussed under Chapter 4.2.1.

Subsection (2) provides that:

> Subject to this section, foreign income derived by a company, at a time when the company is a resident in carrying on a business, at or through a PE of the company in a listed country or unlisted country is not assessable income, and is not exempt income, of the company.

This provision provided the opportunity for branch mismatches to occur. Subsections (4A), (14C) and (14D) were inserted to curtail branch mismatches arising from the branch exemption granted per subsection (2).

Subsection (4A) provides that:

> Subsection (2) does not apply to foreign income derived by the company if the foreign income is branch hybrid mismatch income (see subsection (14C)).

Subsection (14C) determines what branch hybrid mismatch income consists of:

> For the purposes of this section, if foreign income derived by the company is an amount that, for the purposes of Division 832 of the Income Tax Assessment Act 1997, is a payment:
>
> (a) received by the company; and
>
> (b) that, apart from subsection (4A) of this section, would give rise to a branch hybrid mismatch;
>
> then so much of the foreign income as does not exceed the amount of the branch hybrid mismatch is branch hybrid mismatch income.

Subsection (14D) provides that:

> For the purposes of this section, PE, when it is used in Division 832 of the Income Tax Assessment Act 1997, does not have the meaning it has in that Act but instead has the same meaning as in this section.

PE is defined under section 23HA as:

> permanent establishment, or PE, in relation to a listed country or unlisted country:
>
> (a) if there is a double tax agreement in relation to that country—has the same meaning as in the double tax agreement; or
>
> (b) in any other case—has the meaning given by subsection 6(1).

5.7 The challenges experienced by the adopting countries

5.7.1 The United Kingdom

The rules enacted are highly complex and the application thereof is not entirely clear. The amount of information needed in order to take positions in self-assessment tax returns has also proven to be problematic (British Private Equity & Venture Capital Association, 2018:23).

There is also some uncertainty as to whether the hybrid rules should be applied before, after or at the same time as other rules that affect the deductibility of a payment for example, transfer pricing (British Private Equity & Venture Capital Association, 2018:23).

The updated guidance published on 29 November 2017 relating to HMRC's view of how the rules operate should provide some relief with regards to the application issues as stated above. Unfortunately, the guidance only relates to the original version of the rules and not the amended version in the Finance Act 2018 (British Private Equity & Venture Capital Association, 2018:23). It is therefore not certain whether the guidance provided will be of significant value.

According to the British Private Equity & Venture Capital Association (2018) the rules implemented by the United Kingdom do still go further than the OECD BEPS action they were introduced to address (British Private Equity & Venture Capital Association, 2018:27). The aim of the OECD BEPS is to only address mismatches arising from hybrids. The United Kingdom rules go beyond hybrid mismatch arrangements. An example of this is the deeming rule found in Chapter 7 of Part 6A to the TIOPA. This chapter allows that the entire payment to a hybrid entity in a 0% tax jurisdiction can be disallowed even if the mismatch does not arise from a hybrid arrangement (British Private Equity & Venture Capital Association, 2018:27).

5.7.2 New Zealand

The new rules implemented are relatively complex, but it is important to bear in mind that they will have no impact for the vast majority of taxpayers. (Inland Revenue New Zealand, 2018:2). The impact of these provisions will be limited to taxpayers that are currently benefiting from tax arbitrage because of hybrid or branch mismatches (Inland Revenue New Zealand, 2018:2).

The rules were only implemented in 2018 and applying to income years beginning on or after 1 July 2018 and for some provisions only applying to income years beginning on or after 1 January 2020. The legislation is thus still in its infancy and the application thereof has not yet been tested. At the end the first income year, 31 August 2019, the issues in application, implementation and interpretation should be more apparent.

The New Zealand Inland Revenue issued a special report from the Policy and Strategy department relating to hybrid and branch mismatch rules. The special report provides guidance on the application and interpretation of the new sections implemented in the Income Tax Act of 2007. The guidance provided in the aforementioned report should curtail some of the challenges that may be experienced during the implementation of the new rules.

5.7.3 Australia

The provisions enacted are extremely complex and difficult to understand. Australia is a capital importing country and adopting the hybrid mismatch rules may adversely impact the cost of capital for some Australian entities. This impact may be exacerbated relative to other countries that choose not to implement the Action 2 Report recommendations. Adopting the Action 2 Report may affect Australia's competitiveness to attract foreign investment and the costs of Australian companies expanding offshore (Board of Taxation Australia, 2016:17).

The legislation will apply to income years starting on or after 1 January 2019 and some provisions will only apply to income years starting on or after 1 January 2020 (EY, 2018). The issues and challenges experienced in the application, implementation and interpretation will thus only be evident at the end of the first income year, 31 December 2019.

5.8 Conclusion

The United Kingdom, New Zealand and Australia are the early adopters of the OECD recommendations to neutralise hybrid mismatch arrangements.

The United Kingdom was the first country to include provisions addressing hybrid mismatch arrangements in their domestic law and has since been able to pass amendments and issue guidance based on the challenges experienced in the first year of application. The provisions have not yet been challenged in court.

New Zealand's rules were only implemented in 2018 and apply to income years beginning on or after 1 July 2018. Australia's rules will only apply to income years beginning on or after 1 January 2019. The legislation may thus still be amended to respond to possible loopholes and provide clarity where needed.

The United Kingdom only addressed recommendations pertaining to hybrid mismatch arrangements in the legislation implemented as discussed in chapter 5.4.1. It is to be expected that the United Kingdom will in future implement recommendations to neutralise branch mismatch arrangements. The United Kingdom has not given indication as yet to when these provisions will be addressed.

New Zealand implemented the most comprehensive set of OECD Action 2 recommendations as the legislation includes both hybrid and branch mismatch arrangements as discussed in chapter 5.4.2. The rules are in line with the OECD recommendations and are tailored to the New Zealand context. It is still to be seen whether the rules are easily interpreted by taxpayers and fairly easy to apply once the first income year has been completed.

Australia implemented legislation addressing hybrid mismatch arrangements, disregarded branches and branch exemptions as discussed in chapter 5.4.3. Australia has indicated that although the rules do not yet cover branch mismatches, these provisions will be included in due course (Deloitte, 2017).

Australia is the only country to include provisions relating to the limitation of the scope of branch exemptions as proposed by the OECD in recommendation 1 of the branch report. Recommendation 2 and 3 do not apply when recommendation 1 has been implemented. Australia effectively then only still needs to implement provisions relating to recommendation 4 to address double deductions and expand on section 832-H (dealing with imported mismatches) to have a comprehensive set of hybrid and branch mismatch rules.

As South Africa does not have a legislated branch exemption rule the provisions implemented by New Zealand relating to branch mismatch arrangements will be the most appropriate to consider in the analysis to be performed in Chapter 6.

Chapter 6 – Taxation of branch mismatch arrangements from a South African perspective

6.1 Introduction

In this chapter the current domestic legislation applicable to the taxing of local branches of foreign MNE's as well as the legislation applicable to the taxing of a resident MNE's offshore branch will be discussed.

A comparative analysis between the current South African legislation available to address branch mismatch arrangements and the recommendations issued by the OECD will then be performed.

The outcome of a study performed on the effect of tax arbitrage via hybrid mismatches on developing countries will be analysed. The study focused on Columbia, Uruguay, South Africa and Brazil. This will be contrasted against the approaches taken by the selected countries who have already implemented the hybrid mismatch recommendations, which includes the United Kingdom, New Zealand and Australia, to identify the determining factors that will influence the decision of whether or not to adopt the recommendations.

An evaluation will be performed on the types of issues to be considered from a South African perspective should South Africa decide to adopt the recommendations as set out by the OECD.

The chapter will include a detailed discussion on the options available to address the mismatches. This will include the effect on the South African tax base should South Africa choose not to adopt the recommendations versus the effect of adopting the recommendations. The results will be examined for situations where transactions occur with both adopting and non-adopting countries.

6.2 Current domestic legislation

As discussed during the introduction of this report, there are no specific provisions aimed at the taxation of local branches or neutralising the effect of branch mismatch arrangements in South Africa and the general provisions contained in the Income Tax

Act 58 of 1962 (IT Act) are applicable to entities such as local MNE's with offshore branches and local branches of foreign investors.

The lack of specific legislation addressing branch mismatch arrangements indicates that South Africa may indeed be vulnerable to tax arbitrage through these types of arrangements.

The legislation that could be applied to the taxing of local branches of foreign investors and to local MNE's with offshore branches will now be discussed.

6.2.1 Legislation applicable to the taxing of branches in South Africa

South African residents are taxed on their world-wide income in terms of the word definition 'gross income' in section 1 of the Income Tax Act 58 of 1962. Any income earned by a South African resident company through a foreign branch will therefore be included and taxed in the hands of the resident company as part of their gross income. The foreign branch may have been liable for taxation in the foreign country where it conducted its operations. The resident company may qualify for a tax credit based on the tax paid to the foreign government, subject to certain limitations, in terms of section 6quat of the IT Act. Should a tax treaty have been concluded with the foreign country the South African resident company may, in terms of section 6quat(2), exercise a choice between the relief provided for in the tax treaty and the relief provided for under section 6quat(1) or (1C) as appropriate (de Koker & Williams, 2011). The income will thus be included in the local MNE's gross income and relief from double taxation will be provided in the form of either a tax credit or under a treaty provision.

A South African branch of a foreign company will be taxed, in terms of the word definition 'gross income' in section 1 of the Income Tax Act 58 of 1962, on any income earned from a source within South Africa. The branch will be entitled to any deductions it would have been entitled to should it have been a resident of South Africa. The provisions of a double taxation agreement between South Africa and the foreign branch's country of residence may affect the application of the source provisions and limit or prohibit the taxing of the foreign entity.

6.2.2 Legislation that could be applied to neutralise branch mismatch arrangements

The only legislation available that could possibly be used in neutralising branch mismatch arrangements in the South African context is the GAAR contained in sections 80A – 80L of the IT Act.

The GAAR only applies to impermissible tax avoidance arrangements. Section 80A sets out what an impermissible avoidance arrangement is:

> An avoidance arrangement is an impermissible avoidance arrangement if its **sole or main purpose was to obtain a tax benefit** and –
>
> (a) in the context of business –
>
> (i) it was entered into or carried out by means or in a **manner which would not normally be employed for bona fide business purposes**, other than obtaining a tax benefit; or
>
> (ii) it **lacks commercial substance**, in whole or in part, taking into account the provisions of section 80C;
>
> (b) in a context other than business, it was entered into or carried out by means or in **a manner which would not normally be employed for a bona fide purpose**, other than obtaining a tax benefit; or
>
> (c) in any context –
>
> (i) it has **created rights or obligations that would not normally be created between persons dealing at arm's length**; or
>
> (ii) it would result **directly or indirectly in the misuse or abuse of the provisions of this Act** (including the provisions of this Part).

Section 80B deals with the tax consequences of impermissible tax avoidance arrangements:

> (1) The Commissioner may determine the tax consequences under this Act of any impermissible avoidance arrangement for any party by –
>
> (a) disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement;
>
> (b) disregarding any accommodating or tax-indifferent party or treating any accommodating or tax- indifferent party and any other party as one and the same person;
>
> (c) deeming persons who are connected persons in relation to each other to be one and the same person for purposes of determining the tax treatment of any amount;
>
> (d) reallocating any gross income, receipt or accrual of a capital nature, expenditure or rebate amongst the parties;
>
> (e) re-characterising any gross income, receipt or accrual of a capital nature or expenditure; or
>
> (f) treating the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit.

(2) Subject to the time limits imposed by sections 99, 100 and 104(5)(b) of the Tax Administration Act, the Commissioner must make compensating adjustments that he or she is satisfied are necessary and appropriate to ensure the consistent treatment of all parties to the impermissible avoidance arrangement.

Sections 80C – 80G expand on the concepts of impermissible avoidance arrangements as contained in section 80A. Sections 80H – 80K deal with procedural and administrative issues, such as notice and interest. Section 80L defines the terms used in sections 80A – 80B.

6.3 Comparative analysis: Current South African legislation versus. OECD recommendations

The only domestic legislation currently available in South Africa to neutralise branch mismatch arrangements is the GAAR dealing with impermissible avoidance arrangements as discussed under chapter 6.2.2.

The crux of an impermissible avoidance arrangement is whether its sole or main purpose was to obtain a tax benefit. Based on the discussions in the above chapters on branch mismatch arrangements it is clear that these branch mismatches arise from differences in the rules of allocation of income and expenditure between jurisdictions.

Lamers, Mcharo and Nakajima (2014) aptly stated that most tax planning schemes that lead to BEPS are legal and result from an exploitation of an ‘outdated’ international taxation system. These mismatches normally occur during the ordinary course of business in a manner which would normally be employed for bona fide business purposes as a result of the differing legislation between the residence jurisdiction and the branch jurisdiction. Furthermore, the OECD recommends that branch mismatch arrangements should only be neutralised if they occur between parties in the same control group or under a structured arrangement to the extent that the payment is not included in dual inclusion income.

It is often the differences in profit allocation methods in each jurisdiction that create the mismatches, not deliberate tax planning by multinationals, and many of the mismatches would disappear if a consistent approach was taken to profit attribution (Black, 2017). Some branch mismatch arrangements may thus fall short of the requirements of the GAAR as it may be difficult to prove that its sole or main purpose was to obtain a tax benefit and the mismatch arising will thus not be neutralised if the

GAAR is the only available measure in neutralising the mismatch. Even if it can be proven that the sole or main purpose of the branch mismatch arrangement was to obtain a tax benefit the other requirements of section 80A still have to be satisfied in order for the GAAR to be applied. These branch mismatch arrangements may occur in the context of business in a manner which would normally be employed for bona fide business purposes and may have commercial substance therefore falling outside the scope of the GAAR.

It may prove difficult to tax branch mismatch arrangements under the GAAR as very few branch mismatch arrangements will fall within the requirements of the GAAR. The majority of branch mismatch arrangements will thus not be neutralised by the GAAR.

The Davis Tax Committee (2017c:5) sees the GAAR as a port of last call to combat base erosion and profit shifting as envisaged in the OECD's BEPS Action 2.

The GAAR will thus not be as effective in neutralising branch mismatch arrangements as specific provisions incorporating the recommendations of the OECD would be.

6.4 The effect of tax arbitrage via hybrid mismatches on developing countries

As a response to the OECD hybrid mismatch report Kuzniacki et al (2017) posed the question of whether or not tax arbitrage via hybrid mismatches has a particularly distortive impact on the economy of developing countries. A study was performed in this regard on the effect of tax arbitrage via hybrid mismatches on developing countries. The countries included in the study were Columbia, Uruguay, South Africa and Brazil.

Even though the study did not incorporate branch mismatch arrangements and did not take into the account the unique situation of South Africa as an emerging economy and a gateway of investment into the rest of Africa, the results are still deemed relevant in considering branch mismatch arrangements from a South African perspective.

During the study performed it was found that the response from South African stakeholders interviewed to hybrid mismatches differs significantly from the responses received from other countries analysed (Kuzniacki et al, 2017:7). Kuzniacki et al (2017) noted that the South African Government has signalled its concern with hybrid debt instruments and arrangements that create a tax deduction in South Africa without that amount being taxed elsewhere. South Africa has introduced legislative amendments aimed at addressing the issues of international tax arbitrage and hybrid mismatches in relation to hybrid debt instrument rules and debt limitation rules on loans with non-resident connected persons.

Kuzniacki et al (2017) stated that the South African reaction to tax arbitrage via hybrid mismatches likely follows from its membership of the G20. It was further noted that although Brazil is also a member of the G20, its response to hybrid mismatches has not accelerated at the same pace as that of South Africa. The reason for the differing reaction levels was stated as possibly being attributable to a number of different factors such as the willingness of South Africa to pilot or participate as a first adopter to numerous anti-avoidance initiatives (Kuzniacki et al, 2017:7). This indicates that the South African Government may also be willing to participate in the recommendations relating to branch mismatch arrangements.

Kuzniacki et al (2017) is further of the opinion that South Africa has a larger network of treaties facilitating the exchange of information which may be used to facilitate the identification of tax arbitrage via hybrid mismatch arrangements. The same access to the exchange of information will assist in the identification of branch mismatch arrangements. There also appears to be greater engagement with the topic by legal commentators in South Africa in comparison to the other countries investigated.

Based on the study discussed above it appears that South Africa, in contrast to the other developing countries studied, has already taken significant steps in attempting to address tax arbitrage via hybrid mismatch arrangements. The study also shows that South Africa has the resources and capability to facilitate the identification of tax arbitrage via hybrid mismatch arrangements which the other countries studied do not have at this stage.

6.5 Issues to be considered

There are several types of issues to be considered by South Africa when planning to adopt the recommendations as set out by the OECD. Some of these issues and considerations will now be discussed.

As indicated during the introductory chapter of this research report the Minister of Finance has tasked the Davis Tax Committee to provide recommendations on how South Africa can incorporate the OECD's minimum standards, best practice guidelines and international standards on BEPS into its international tax framework. This is a similar approach to the one taken by New Zealand in performing their regulatory impact assessment. In their report the Davis Tax Committee indicated some determining factors that will influence South Africa's decision of whether or not to adopt the recommendations.

The issues considered by New Zealand during the regulatory impact assessment and the OECD proposed implementation measures discussed under chapter 5.5 should also be taken into account by South Africa in determining whether the branch mismatch rules should be adopted or not. It is important to note that the analysis performed by New Zealand was limited by the inability to assess the exact size of the hybrid and branch mismatch arrangements problem in New Zealand (Inland Revenue New Zealand, 2017a:3). This was owing to the fact that under current law Inland Revenue's investigations staff do not routinely examine offshore tax treatment (and therefore arrangements that lower a group's worldwide tax obligations), which is an important part of identifying a hybrid mismatch arrangement under the proposals (Inland Revenue New Zealand, 2017a:3). The same limitation will be experienced in South Africa as the South African Revenue Service (SARS) does not perform routine audits or investigations on the offshore tax treatment of MNE's in a manner that would identify hybrid or branch mismatch arrangements. It would thus be extremely difficult to accurately determine the extent and value of tax arbitrage through branch mismatch arrangements in South Africa.

The Inland Revenue New Zealand (2017a:5) made it clear that they are committed to ensuring that New Zealand remains an attractive place for non-residents to invest which is aligned with South Africa's NDP goal. The provisions legislated by New Zealand as discussed in chapter 5.6.2 should thus be relevant in the consideration by South Africa on possible provisions to be enacted as there is the common goal of reducing tax arbitrage through branch mismatch arrangements whilst still promoting FDI.

The Davis Tax Committee (2017a:21) also considered policy considerations that South Africa should take into account before adopting the OECD recommendations on Action 2 relating to hybrid mismatch arrangements. The considerations include the following:

- The technical requirements to trace and link the deductibility of payments with the treatment in the counterparty jurisdictions can be complex and resource intensive (Davis Tax Committee, 2017a:21);
- The impact on the competitiveness of home-grown multinationals needs to be determined in instances where South Africa would adopt the recommendations against instances where South Africa does not adopt the recommendations (Davis Tax Committee, 2017a:21);
- Legislative simplicity is critical in this complex area of tax (Davis Tax Committee, 2017a:25). The legislation should be clear and unambiguous; easy to administer and to comply with (Davis Tax Committee, 2017b:39);
- The BEPS risk should be balanced with attracting foreign direct investment. South Africa should aim to increase its pull on and compete for a larger stake in the investments flowing into its Brazil, Russia, India and China BRIC counterparts (Davis Tax Committee, 2017a:25);
- It is essential to achieve equilibrium between nurturing cross-border trade and investment while simultaneously narrowing the scope of tax avoidance (Davis Tax Committee, 2017a:25);
- Balancing the protection of the tax base and the ensuring the competitiveness of the economy (Davis Tax Committee, 2017b:34);
- South Africa cannot take action without considering the global environment and other countries' responses to the concerns (Davis Tax Committee, 2017b:36);
- The unilateral introduction of domestic legislation in anticipation of global reforms could result in a less investor friendly tax environment and may place South Africa at a disadvantage compared to other jurisdictions without BEPS legislation, in attracting much needed foreign direct investment (Davis Tax Committee, 2017b:36);
- Legislation should be drafted clearly instead of requiring reliance on explanatory memorandums and interpretation notes which are not legally binding (Davis Tax Committee, 2017b:39);
- There should be a balance between revenue collection and growth (Davis Tax Committee, 2017b:48);
- At an administrative level, the use of proper forms should be attended to, to ensure proper detection of BEPS (Davis Tax Committee, 2017b:52).

The considerations vary from legislative aspects to administrative and economic concerns. It is extremely important to strike a balance between the positive and negative effects that the implementation of the recommendations of the OECD Action 2 BEPS report may have.

South Africa will furthermore need to consider which of the options as identified in the New Zealand regulatory impact assessment discussed in chapter 5.3 will be most appropriate to address the concerns raised above. It would seem that the tailored approach as implemented by the United Kingdom, New Zealand and Australia would be the preferred approach should South Africa decide to implement the recommendations of the OECD Action 2 BEPS report.

Basnett (2015) is of the opinion that despite similar tax systems, South Africa and Australia vary greatly in terms of their economic and social position. South Africa, as a developing country, is more likely than Australia to tolerate BEPS behaviour in order to maintain or even attract foreign investment. This may indicate that South Africa would not be willing to enact recommendations which would have an adverse effect on FDI, but would rather allow some BEPS behaviour in order to boost foreign investment. This issue again highlights the importance of striking a balance between responding to the BEPS risk and still achieving the necessary stimulation of growth as set out in the NDP.

6.6 Options available to address the mismatches and the effects thereof

A detailed discussion on the options available to address the mismatches and the resulting outcomes will now be undertaken. The options available were discussed in detail in chapter 5.3. Based on the analysis performed on the approaches taken by the selected countries it is clear that the tailored option as discussed in chapter 5.3.2 was the most appropriate.

Taking the issues to be considered by South Africa as discussed in chapter 6.5 into account, the most appropriate option for South Africa would also be the tailored option should the decision be taken to adopt the OECD recommendations. The alternative would be status quo where no action is taken and the GAAR can then be used in an attempt to neutralise some branch mismatches that fall within the scope thereof.

The comparative analysis performed in this chapter will include the effect on the South African tax base should South Africa choose not to adopt the recommendations versus the effect of adopting the recommendations.

The results will be examined for situations where transactions occur with both adopting and non-adopting countries. Furthermore, the analysis will be performed for local branches of foreign entities and foreign branches of South African residents.

The following recommendations and the related options and outcomes will now be addressed as indicated below:

- Recommendation 1 is only applicable to the head office jurisdiction and will be discussed in 6.6.1.
- Recommendation 2 is only applicable to the payer jurisdiction and will be discussed under 6.6.3.
- Recommendation 3 is applicable to both the branch and payer jurisdiction (if different) and will be discussed under 6.6.2 and 6.6.3.
- Recommendation 4 contains a primary and a defensive rule. The primary rule is applicable to the head office jurisdiction will be discussed under 6.6.1. The defensive rule is applicable to the branch jurisdiction and will be discussed under 6.6.2.
- Recommendation 5 is only applicable to the payer jurisdiction and will be discussed under 6.6.3.

6.6.1 Offshore branch of a South African resident

The effects on the taxability of a South African resident with an offshore branch will be investigated for a situation where South Africa chooses to adopt the OECD recommendations versus the effects should South Africa choose not to adopt the OECD recommendations.

6.6.1.1 South Africa chooses to adopt the recommendations

The outcome for each applicable recommendation as set out in the OECD branch report and discussed in chapter 4.2 will now be examined on the basis that South Africa as the head office or investor jurisdiction chose to adopt the OECD recommendations.

The following recommendations would be applicable to the head office jurisdiction:

- Recommendation 1 relates to the limitation of the scope of the branch exemption granted by the head office. South African domestic legislation does not contain any provisions relating to the granting of branch exemptions and therefore recommendation 1 dealing with the limitation of branch exemptions will not be discussed further as there is no application for the rule.

- Recommendation 4 relating to double deductions is the main rule that would apply to South Africa as the head office jurisdiction.

6.6.1.1.1 Transacting with both an adopting country a non-adopting country

The primary rule under recommendation 4 requires that the investor jurisdiction restrict the deductibility of any payment, expense or loss which is deductible under the laws of both jurisdictions, so that such amount can only be set off against dual inclusion income.

By implementing this recommendation South Africa's tax base is protected. The group tax benefit is extinguished and the South Africa's tax base is not reduced with a double deduction.

6.6.1.2 South Africa chooses to not adopt the recommendations

The outcome for each applicable recommendation as set out in the OECD branch report and discussed in chapter 4.2 will now be examined on the basis that South Africa as the head office or investor jurisdiction chose not to adopt the OECD recommendations.

Recommendation 4 relating to double deductions is the main rule that would apply to South Africa as the head office jurisdiction.

6.6.1.2.1 Transacting with an adopting country

The defensive rule under recommendation 4 requires that the payer jurisdiction restrict the deductibility of any payment, expense or loss which is deductible under the laws of both jurisdictions, so that such amount can only be set off against dual inclusion income. The defensive rule is only applicable when the effect of the mismatch is not neutralised in the investor jurisdiction. The branch jurisdiction can thus opt to apply the rule if South Africa as the investor jurisdiction fails to implement the primary rule as set out in recommendation 4.

Should the branch jurisdiction implement the defensive rule the branch jurisdiction would be able to disallow the deduction and the branch jurisdiction would thus benefit. The group tax benefit will still be extinguished, but South Africa's tax base will be reduced with revenue that it would have been entitled to if the recommendations of the branch report had been implemented.

South Africa would thus be losing tax revenue that it is entitled to and the tax base would be reduced.

6.6.1.2.2 Transacting with a non-adopting country

As neither the head office or branch jurisdiction adopted branch mismatch rules the mismatch will not be neutralised. The double deduction would not be disallowed and a DD outcome would still exist. The group tax benefit will not be extinguished and a branch mismatch would result in lost revenue for both countries involved.

6.6.1.3 Conclusion

Should South Africa decide not to implement recommendation 4 its tax base will be reduced with a double deduction which is set off against an amount that is not dual inclusion income. By transacting with an adopting country a portion of South Africa's tax revenue will be collected by that country. By transacting with a non-adopting country the chance of the mismatch being neutralised by current domestic provisions such as GAAR is slim. The non-adoption of recommendation 4 will be to the detriment of South Africa as an investor jurisdiction of home-grown MNEs.

The adoption of recommendation 4 will thus be beneficial to South Africa as it increases its tax base by denying a double deduction that is being set off against an amount that is not dual inclusion income. The implementation of recommendation 4 by South Africa as an investor jurisdiction should yield additional revenue.

6.6.2 South African branch of a foreign company

The effects on the taxability of a South African branch of a foreign company will now be investigated for a situation where South Africa chooses to adopt the OECD recommendations versus the effects should South Africa choose not to adopt the OECD recommendations.

6.6.2.1 South Africa chooses to adopt the recommendations

The outcome for each applicable recommendation as set out in the OECD branch report and discussed in chapter 4.2 will be examined on the basis that South Africa chose to adopt the OECD recommendations.

The following recommendations are applicable in this regard:

- Recommendation 3 relating to notional branch payments and is applicable to the branch jurisdiction as a payer jurisdiction.
- Recommendation 4 relating to double deductions and is applicable to the branch jurisdiction if the head office jurisdiction does not adopt the recommendations relating to branch mismatch arrangements.

6.6.2.1.1 Transacting with an adopting country

Recommendation 3 calls for the payer jurisdiction to disallow the deduction for the deemed branch payment to the extent that the payment is disregarded by the payee and not set off against dual inclusion income.

Recommendation 4 provides a defensive rule that can be implemented by the branch jurisdiction as discussed above in 6.6.1.2.1.

<u>Recommendation 3</u>

If South Africa implements recommendation 3, the deemed payment which does not result in taxable income being raised by the residence jurisdiction will be disallowed. This protects the South African tax base against the deduction of a payment which is not included in the taxable income of a counterparty. The group tax benefit is extinguished and the South Africa’s tax base is not reduced with a deemed payment.

The application of recommendation 3 will depend on whether the head office jurisdiction has implemented a rule, consistent with recommendation 1.1 of the branch report, that results in an overall allocation of net income to the head office which would be consistent with recognising the effect of the deemed payment. If such a rule has been applied then the mismatch in tax outcomes would have been neutralised and there will be no scope for the operation of the deemed branch payment mismatch rule.

Recommendation 4

It is expected that when transacting with an adopting country the head office jurisdiction will implement the primary rule in respect of recommendation 4 and South Africa will not be able to apply the defensive rule to neutralise the mismatch.

6.6.2.1.2 Transacting with a non-adopting country

Recommendation 3

If South Africa implements recommendation 3 the deemed payment which does not result in taxable income being raised by the residence jurisdiction will be disallowed. This protects the South African tax base. The group tax benefit is extinguished and the South Africa’s tax base is not reduced with a deemed payment.

Recommendation 4

When transacting with a non-adopting country South Africa will be able to apply the defensive rule contained in recommendation 4 to neutralise the mismatch. By implementing this recommendation South Africa’s tax base is protected. The group tax benefit is extinguished and the South Africa’s tax base is not reduced with a double deduction.

6.6.2.2 South Africa chooses to not adopt the recommendations

The consequence for each applicable recommendation as set out in the OECD branch report and discussed in chapter 4.2 will be examined on the basis that South Africa chose not to adopt the OECD recommendations.

6.6.2.2.1 Transacting with an adopting country

Recommendation 3

If the head office jurisdiction has implemented a rule consistent with recommendation 1.1 of the branch report the payment allowed as a deduction would be raised as taxable income in the residence jurisdiction and would thus not result in a D\NI outcome. The branch mismatch will effectively be neutralised if the scope of the branch exemption granted by the residence jurisdiction was limited regardless of whether South Africa as branch jurisdiction implements the recommendation.

Should no rule similar to recommendation 1.1 as discussed above be implemented by the residence jurisdiction the mismatch will not be neutralised. The deemed payment would not be disallowed and a D/NI outcome would still exist. The group tax benefit will not be extinguished and a branch mismatch would result in lost revenue.

Recommendation 4

It is expected that when transacting with an adopting country the head office jurisdiction will implement the primary rule in respect of recommendation 4 and South Africa will not be able to apply the defensive rule to neutralise the mismatch. It therefore has no impact.

6.6.2.2.2 Transacting with a non-adopting country

Recommendation 3

As neither the head office or branch jurisdiction adopted branch mismatch rules the mismatch will not be neutralised. The deemed payment would not be disallowed and a D/NI outcome would still exist. The group tax benefit will not be extinguished and a branch mismatch would result in lost revenue.

Recommendation 4

As neither the head office or branch jurisdiction adopted branch mismatch rules the mismatch will not be neutralised. The double deduction would not be disallowed and a DD outcome would still exist. The group tax benefit will not be extinguished and a branch mismatch would result in lost revenue.

South Africa will be losing out on tax revenue that it would have been entitled to under the defensive rule if the decision had been taken to adopt recommendation 4.

6.6.2.3 Conclusion

Recommendation 3

Should South Africa decide not to implement recommendation 3 its tax base will be reduced with a deemed payment which does not result in taxable income being raised by a counterparty in the group. The group as a whole will receive a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of South Africa.

Should the residence jurisdiction implement a rule similar to recommendation 1 South Africa would not be able to apply recommendation 3 and will have to allow the deduction. The payment allowed as a deduction would be raised as taxable income in the residence jurisdiction and would thus not result in a D\NI outcome. The group tax benefit will still be extinguished and a branch mismatch would no longer exist.

The adoption of recommendation 3 will thus be beneficial to South Africa as it increases its tax base by denying a deduction that is being set off against an amount that is not dual inclusion income in instances where no branch exemption limitation exists.

Recommendation 4

Should South Africa implement the defensive rule South Africa as the branch jurisdiction would be able to disallow the deduction and would thus benefit. The double deduction would be disallowed and a DD outcome would no longer exist. The group tax benefit will still be extinguished and a branch mismatch would no longer exist.

The adoption of recommendation 4 will thus be beneficial to South Africa as branch jurisdiction when dealing with non-adopting countries as it increases its tax base by denying a double deduction that is being set off against an amount that is not dual inclusion income.

6.6.3 South African resident payer

The effects on the taxability of a South African resident who is the payer in a branch mismatch situation will now be investigated for a situation where South Africa chooses to adopt the OECD recommendations versus the effects should South Africa choose not to adopt the OECD recommendations.

6.6.3.1 South Africa chooses to adopt the recommendations

The outcome for each applicable recommendation as set out in the OECD branch report and discussed in chapter 4.2 will be examined on the basis that South Africa chose to adopt the OECD recommendations.

The following recommendations are applicable in this regard:

- Recommendation 2 relating to payments made to diverted and disregarded branches by a payer.
- Recommendation 3 relating to notional branch payments made by a payer.

- Recommendation 5 relating to payments by the payer funding imported branch mismatches.

6.6.3.1.1 Transacting with an adopting country

Recommendation 2 calls for the payer jurisdiction to disallow the deduction to the extent that the payment is not included in the income of either the head office or the branch, if the mismatch is as a result of a disregarded branch structure or a diverted branch structure.

Recommendation 3 calls for the payer jurisdiction to disallow the deduction for the deemed branch payment to the extent that the payment is disregarded by the payee and not set off against dual inclusion income.

Recommendation 5 calls for the payer jurisdiction to deny a deduction for any payment made under an imported branch mismatch arrangement to the extent that such payment directly or indirectly funds deductible expenditure under a branch mismatch arrangement. The recommendation does not apply to the extent that one of the jurisdictions has made an equivalent adjustment in respect of such branch mismatch.

<u>Recommendation 2</u>

If South Africa implements recommendation 2 the deduction which does not result in taxable income being raised by a counterparty in the group will be disallowed. This protects the South African tax base by not allowing a payment which is not matched against taxable income in either the residence or branch jurisdiction to be deducted. The group tax benefit is extinguished and South Africa's tax base is not reduced with a branch mismatch arrangement.

The application of recommendation 2 will depend on whether the head office jurisdiction has implemented a rule consistent with recommendation 1.1 of the branch report that results in an overall allocation of net income to the head office which would be consistent with recognising the effect of the payment. If such a rule has been applied then the mismatch in tax outcomes would have been neutralised and there will be no scope for the operation of the branch payee mismatch rule.

<u>Recommendation 3</u>

If South Africa implements recommendation 3 the deemed payment which does not result in taxable income being raised by the residence jurisdiction will be disallowed.

This protects the South African tax base. The group tax benefit is extinguished and the South Africa's tax base is not reduced with a deemed payment.

The application of recommendation 3 will depend on whether the head office jurisdiction has implemented a rule, consistent with recommendation 1.1 of the branch report, that results in an overall allocation of net income to the head office which would be consistent with recognising the effect of the deemed payment. If such a rule has been applied then the mismatch in tax outcomes would have been neutralised and there will be no scope for the operation of the deemed branch payment mismatch rule.

Recommendation 5

If South Africa implements recommendation 5 the deduction funding deductible expenditure under a branch mismatch arrangement will be disallowed. This protects the South African tax base by not allowing a payment which is not matched against taxable income in either the residence or branch jurisdiction to be deducted. The group tax benefit is extinguished and the payer jurisdiction's tax base is not reduced with an imported branch mismatch arrangement.

6.6.3.1.2 Transacting with a non-adopting country

Recommendation 2

If South Africa implements recommendation 2 the deduction which does not result in taxable income being raised by a counterparty in the group will be disallowed. This protects the South African tax base by not allowing a payment which is not matched against taxable income in either the residence or branch jurisdiction to be deducted. The group tax benefit is extinguished and South Africa's tax base is not reduced with a branch mismatch arrangement.

Recommendation 3

If South Africa implements recommendation 3 the deemed payment which does not result in taxable income being raised by the residence jurisdiction will be disallowed. This protects the South African tax base. The group tax benefit is extinguished and the South Africa's tax base is not reduced with a deemed payment.

Recommendation 5

If South Africa implements recommendation 5 the deduction funding deductible expenditure under a branch mismatch arrangement will be disallowed. This protects the South African tax base by not allowing a payment which is not matched against taxable income in either the residence or branch jurisdiction to be deducted. The group tax benefit is extinguished and the payer jurisdiction's tax base is not reduced with an imported branch mismatch arrangement.

6.6.3.2 South Africa chooses to not adopt the recommendations

The consequence for each applicable recommendation as set out in the OECD branch report and discussed in chapter 4.2 will be examined on the basis that South Africa chose not to adopt the OECD recommendations.

6.6.3.2.1 Transacting with an adopting country

Recommendation 2

If the head office jurisdiction has implemented a rule consistent with recommendation 1.1 of the branch report the payment allowed as a deduction would be raised as taxable income in the residence jurisdiction and would thus not result in a D\NI outcome. The branch mismatch will effectively be neutralised if the scope of the branch exemption granted by the residence jurisdiction was limited regardless of whether South Africa as payer residence implements the recommendation.

Should no rule similar to recommendation 1.1 as discussed above be implemented by the residence jurisdiction the mismatch will not be neutralised. The deemed payment would not be disallowed and a D/NI outcome would still exist. The group tax benefit will not be extinguished and a branch mismatch would result in lost revenue.

Recommendation 3

If the head office jurisdiction has implemented a rule consistent with recommendation 1.1 of the branch report the payment allowed as a deduction would be raised as taxable income in the residence jurisdiction and would thus not result in a D\NI outcome. The branch mismatch will effectively be neutralised if the scope of the branch exemption granted by the residence jurisdiction was limited regardless of whether South Africa as branch residence implements the recommendation.

Should no rule similar to recommendation 1.1 as discussed above be implemented by the residence jurisdiction the mismatch will not be neutralised. The deemed payment would not be disallowed and a D/NI outcome would still exist. The group tax benefit will not be extinguished and a branch mismatch would result in lost revenue.

<u>Recommendation 5</u>

Should South Africa decide not to implement recommendation 5, its tax base will be reduced with a payment funding deductible expenditure under a branch mismatch arrangement. The group as a whole will receive a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of South Africa.

Should the one of the jurisdictions, either the branch or the head office, have implemented branch mismatch rules and make an equivalent adjustment in respect of such branch mismatch, the branch mismatch will effectively be neutralised.

6.6.3.2.2 Transacting with a non-adopting country

<u>Recommendation 2</u>

As neither the head office or branch jurisdiction adopted branch mismatch rules the mismatch will not be neutralised. The deemed payment would not be disallowed and a D/NI outcome would still exist. The group tax benefit will not be extinguished and a branch mismatch would result in lost revenue.

<u>Recommendation 3</u>

As neither the head office or branch jurisdiction adopted branch mismatch rules the mismatch will not be neutralised. The deemed payment would not be disallowed and a D/NI outcome would still exist. The group tax benefit will not be extinguished and a branch mismatch would result in lost revenue.

<u>Recommendation 5</u>

As none of the parties involved adopted branch mismatch rules the mismatch will not be neutralised. The deemed payment would not be disallowed and a D/NI outcome would still exist. The group tax benefit will not be extinguished and an imported branch mismatch would result in lost revenue.

6.6.3.3 Conclusion

<u>Recommendation 2</u>

Should South Africa decide not to implement recommendation 2 its tax base will be reduced with a payment which does not result in taxable income being raised by a counterparty in the group. The group as a whole will receive a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of the South Africa.

Should the residence jurisdiction implement a rule similar to recommendation 1.1 South Africa would not be able to apply recommendation 2 and will have to allow the deduction. The payment allowed as a deduction would be raised as taxable income in the residence jurisdiction and would thus not result in a D\NI outcome. The group tax benefit will still be extinguished and a branch mismatch would no longer exist.

The adoption of recommendation 2 will thus be beneficial to South Africa as the payer jurisdiction as it increases its tax base by denying a deduction which does not result in taxable income being raised by a counterparty in the group in instances where no branch exemption limitation exists.

<u>Recommendation 3</u>

Should South Africa decide not to implement recommendation 3 its tax base will be reduced with a deemed payment which does not result in taxable income being raised by a counterparty in the group. The group as a whole will receive a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of South Africa.

Should the residence jurisdiction implement a rule similar to recommendation 1.1 South Africa would not be able to apply recommendation 3 and will have to allow the deduction. The payment allowed as a deduction would be raised as taxable income in the residence jurisdiction and would thus not result in a D\NI outcome. The group tax benefit will still be extinguished and a branch mismatch would no longer exist.

The adoption of recommendation 3 will thus be beneficial to South Africa as it increases its tax base by denying a deduction that is being set off against an amount that is not dual inclusion income in instances where no branch exemption limitation exists.

Recommendation 5

Should South Africa as the payer jurisdiction decide not to implement recommendation 5 its tax base will be reduced with a payment funding deductible expenditure under a branch mismatch arrangement. The group as a whole will receive a tax benefit it would not otherwise have been entitled to if no branch mismatch existed to the detriment of South Africa.

Should either the residence or branch jurisdiction have implemented branch mismatch rules and have made an equivalent adjustment in respect of such branch mismatch the branch mismatch will have effectively been neutralised. South Africa would not be able to apply recommendation 5 and will have to allow the deduction. The payment allowed as a deduction would be raised as taxable income in the residence or branch jurisdiction and would thus not result in a D\NI outcome. The group tax benefit will still be extinguished and a branch mismatch would no longer exist.

The adoption of recommendation 5 will thus be beneficial to South Africa as it increases its tax base by denying a deduction funding deductible expenditure under an imported branch mismatch arrangement in circumstances where none of the counterparty jurisdictions implemented branch mismatch rules.

6.7 Conclusion

South Africa does not have specific legislation that can be applied in neutralising branch mismatch arrangements. The GAAR can be used in an attempt to address branch mismatch arrangements, but would not be successful in counteracting the majority of branch mismatch arrangements as the crucial element of whether its sole or main purpose was to obtain a tax benefit will not be met with the majority of arrangements as discussed in chapter 6.3.

The possible challenges and the possible consequences of adopting the recommendations have also been discussed in this chapter. It is clear that proper planning is needed to ensure that the proposed legislation has maximum impact, but does not discourage FDI. It is also important that the implementation of rules to neutralise branch mismatch arrangements should not prejudice home grown MNEs.

The Davis Tax Committee (2017b:48) placed emphasis on the fact that 'the main concern of the OECD BEPS Action Plan is about addressing in-bound issues which involve foreign multinationals investing in a country without paying their fair share of corporate income tax to that country'. Nevertheless, responding to these BEPS issues should not be seen as discouraging foreign investment.

During the analysis performed under chapter 6.6 it was found that in the majority of the scenarios it would be in the interest of South Africa to adopt the OECD recommendations relating to branch mismatch arrangements. The adoption will result in regaining some portion of tax revenue lost to BEPS and will assist in protecting South Africa's tax base.

Chapter 7 – Conclusions and recommendations

7.1 Research findings and summarising remarks

The objective of this research report was to determine the importance and relevance of addressing BEPS via branch mismatch arrangements, as proposed by the Organisation for Economic Co-operation and Development (OECD), to an emerging economy such as South Africa. This was achieved by performing a literature review of current income tax legislation, journal articles, dissertations, publications by international and government organisations, conference proceedings and presentations relating to hybrid and branch mismatch arrangements.

In chapter 2 the concept of hybrid mismatch arrangements was discussed and examined as a starting point to understanding branch mismatch arrangements. The chapter focused on the underlying elements found in hybrid mismatch arrangements, the effects of these arrangements, the possible outcomes, the tax policy issues that arise from the use of hybrid mismatch arrangements and the possible policy options which can be implemented to address the hybrid mismatch arrangements. It was found that hybrid mismatch arrangements can be structured in many ways depending on the domestic laws of the specific countries involved and the tax treaties that may be applicable. It may therefore by extremely difficult for revenue authorities to identify whether a hybrid mismatch has occurred without having some insight into the specifics of the arrangement and lacking a proper understanding of the domestic law policies of all the countries involved. It was identified that hybrid entities and branches have some similarities, but the vast differences in operation and governing legislation necessitated a separate set of rules which prompted the creation of the branch report.

In chapter 3 the focus was moved to the concept of branch mismatch arrangements. The basic types of branch mismatches, the possible outcomes of these mismatches and the challenges experienced by tax authorities in relation to these arrangements were examined. A detailed analysis of possible mismatch arrangements was performed to determine the impact of these arrangements on a country's tax base with reference to the 2017 branch report. It was determined that branch mismatch arrangement structures can be extremely complex and it can be difficult to identify the actual country losing revenue. Furthermore, tax authorities are seldom equipped with the knowledge or skilled in the laws of other jurisdictions that may form part of the branch mismatch arrangement structure.

In chapter 4 the OECD recommendations to neutralise the effect of each category of branch mismatch were analysed. The scope and impact of the recommendations proposed by the OECD were examined. The concerns raised by stakeholders and academics in relation to the adoption of the recommendations were also discussed. It was concluded that the recommendations provided by the OECD in mitigating branch mismatch arrangements are complex and the types of branch mismatches that could be occurring is vast. It would thus be impossible for the OECD to cover every possible structure that may arise in the recommendations presented in the branch report.

In chapter 5 an analysis of the approaches taken by selected countries such as the United Kingdom, New Zealand and Australia in adopting the OECD branch report recommendations were conducted. The available options in adopting the recommendations, the issues to be considered and the challenges experienced by these selected countries were investigated. The amendments made to the domestic legislation of the selected countries to enact the recommendations from the branch report were studied in detail. It was found that all the countries considered applied a tailored approach in adopting the OECD recommendations to neutralise branch mismatch arrangements. New Zealand was found to have implemented the most comprehensive set of hybrid and branch mismatch rules of the countries considered.

Chapter 6 examined the current domestic legislation applicable to the taxing of local branches of foreign MNE's as well as the legislation applicable to the taxing of a resident MNE's offshore branch. A comparative analysis between the current South African legislation available to address branch mismatch arrangements and the recommendations issued by the OECD was performed. It was found that South Africa lacked legislation that would efficiently neutralise the types of branch mismatch arrangements identified in this research report. An evaluation was performed on the types of issues to be considered when planning to adopt the recommendations as set out by the OECD and to identify the determining factors that would influence the decision of whether or not to adopt the recommendations. An analysis was performed to determine the effect on the South African tax base should South Africa choose not to adopt the recommendations versus the effect of adopting the recommendations. The results were examined for situations where transactions occur with both adopting and non-adopting countries. During the analysis performed it was found that in the majority of the scenarios it would be in the interest of South Africa to adopt the OECD recommendations relating to branch mismatch arrangements.

7.2. Recommendations

It is submitted that South Africa does not have sufficient safeguards in place to protect its tax base against base erosion and profit shifting arising through the use of branch mismatch arrangements. This results in lost revenue and a reduction of the South African tax base. The implementation of some of the recommendations of the branch report through the use of a tailored approach will allow South Africa to reduce its exposure to lost tax revenue arising from branch mismatch arrangements. By adopting some form of rules to align the domestic legislation of South Africa with the recommendations of the OECD the opportunity for tax arbitrage resulting in double non-taxation will be reduced. This will align the tax treatment with other countries that chose to adopt the OECD branch mismatch recommendations and contribute to closing the tax gap. South Africa will be in a better position as an adopting country when transacting with both an adopting or non-adopting country than it would be as a non-adopting country based on the comparative analysis performed in chapter 6.6.

The branch mismatch rules implemented by New Zealand are comprehensive, clearer and more concise than the rules implemented by the United Kingdom and Australia and may provide guidance as to certain amendments that can be considered. The challenges experienced and the issued considered by these countries will also give insight on the implementation and administration process.

It is important that a balance is attained between the fight against BEPS and stimulating FDI to achieve the necessary stimulation of growth as set out in the NDP. Based on this report future research should be conducted on the effect the implementation of the OECD BEPS recommendation may have on the economic growth of South Africa. An analysis should be performed on the impact the possible legislative changes to incorporate the branch mismatch rules will have on home grown MNEs, on MNEs using South Africa as an investment gateway into Africa and foreign companies trading through branches in South Africa.

It may be necessary for the Davis Tax Committee to review the need for implementation of the identified recommendations in order to inform the decision to be taken by Government. The review would have to include the proposed legislation that will be effective in addressing branch mismatch arrangements in a South African setting.

The adoption of the branch mismatch rules will be beneficial to South Africa when contracting with other adopting countries. It will ensure that the tax revenue that South Africa is entitled to does not revert to the other country as a result of the secondary branch rules mismatch rules which benefits the other country. The implementation will assist in protecting South Africa's tax base and may even assist in increasing the tax base by allowing South Africa to tax branch mismatches when contracting with non-adopting countries.

As a member of the G20 and the BEPS Steering Committee it is of interest and relevance to South Africa's economy to amend the domestic legislation in line with the OECD recommendations relating to branch mismatch arrangements.

Based on this report a comprehensive study should be performed to analyse the specific types of branch mismatch arrangements South Africa is exposed to. This would guide the legislative requirements and inform on which provisions would add value to the South African tax base. This would assist in designing specific legislation to curb tax arbitrage through the use of branch mismatch arrangements in South Africa.

8. References

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