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The Treatment of Branches in the §267A Regulations

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Branches give rise to difficult international issues under the tax law and under tax treaties. This is particularly so, because any two countries do not always agree on what a branch is and how it should be taxed. The final anti-hybrid regulations under §267A [1] contain two sets of rules dealing with branches. The first set, the deemed branch payment rules, picks up on an explicit grant of authority in the statute: Section 267A(e)(2) specifically authorizes the IRS to provide "rules for the application of this section [267A] to branches or domestic entities." The second set of rules, however, ventures far beyond the reach of the statute, addressing what are referred to as "branch mismatch payments." This article will address each set of rules in turn.

[1] All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

The deemed branch payment rules begin by defining the term "specified party" specifically to include a "U.S. taxable branch." The preamble to the proposed regulations stated that the term "specified party" includes a U.S. taxable branch "because a payment made by the home office may be allocable to and thus reduce income subject to U.S. tax under sections 871(b) or 882." [2]

[2] Preamble Explanation of Provisions at Part II.B.2.

A branch is "a taxable presence of a tax resident in a country other than its country of residence as determined under either the tax resident's tax law or such other country's tax law." [3] A "taxable branch" is one that "has a taxable presence under its tax law," [4] where "its" presumably refers to the law of the country in which the branch is located, as opposed to the country of its owner's residence. The difference between a mere branch and a taxable branch is that the former may not actually be taxable in the country where it is located. A "U.S. taxable branch" is defined in the regulations as

[3] Reg. §1.267A-5(a)(2).

[4] Reg. §1.267A-5(a)(22) (emphasis added).

> a trade or business carried on in the United States by a tax resident of another country, except that if an income tax treaty applies, the term means a permanent establishment of a tax treaty resident eligible for benefits under an income tax treaty between the United States and the treaty country. Thus, for example, a U.S. taxable branch includes a U.S. trade or business of a foreign corporation taxable under section 882(a) or a U.S. permanent establishment of a tax treaty resident. [5]

[5] Reg. §1.267A-5(a)(25). The additional words in this definition are likely traceable to the fact that most countries do not distinguish between a "branch" and a "permanent establishment," whereas U.S. tax law contains no concept of a permanent establishment, a term that is used only in U.S. tax treaties.

Reg. §1.267A-2(c)(1) provides that if a specified payment constitutes a deemed branch payment, it is treated as a disqualified hybrid amount if the payment is not taxed in the country of the home office. Reg. §1.267A-2(c)(2) defines a deemed branch payment as any amount of interest or royalties allowable as a deduction in computing the business profits of a U.S. taxable branch, to the extent (1) the amount is deemed paid to the home office (or other branch of the home office), (2) the payment is not regarded or otherwise taken into account under the home office's tax law (or the other branch's tax law), and (3) if the payment were regarded and treated as interest or a royalty, the home office (or other branch) would include the payment in income. Note that the definition of deemed branch payment includes both actual payments and deemed payments.

To apply this rule, one needs to know how to calculate the amount of interest or royalties allowable as a deduction in computing the business profits of a U.S. taxable branch. This is a function of U.S. tax law. U.S. domestic tax law provides one set of rules for determining how to calculate interest or royalties deemed paid by a branch, and a different set of rules where a tax treaty applies. Reg. §1.267A-5(b)(3)(i) incorporates both sets of rules. Absent an applicable tax treaty, the amount of interest or royalty subject to the rule is the amount allocable to effectively connected income ("ECI") of the U.S. taxable branch under §873(a) or §882(c)(1). Where a tax treaty applies, the amount is the same as the amount of interest or royalty allowable in computing the business profits attributable to the U.S. permanent establishment. Under most treaties, that amount is calculated under the "authorized OECD approach" based on the amount of interest or royalties the branch would pay if it were a separate entity. The regulation then goes into more detail on how to determine to whom the amount of interest or royalties is deemed paid. [6] But it's easy to lose the important point in the weeds of those details, so let's turn to the example set forth in Reg. §1.267A-6(c)(4).

[6] Reg. §1.267A-5(b)(3)(ii).

The first part of the example involves actual payments of interest by the foreign entity that has a U.S. taxable branch. In the example, FX1 and FX2 are foreign corporations each of which is tax resident in Country X. FX2 is a wholly owned subsidiary of FX1 and is included in a consolidated return with FX1. FX2 has a U.S. taxable branch, USB. FX2 has $200 of gross income from which it makes two kinds of payments. The first is a payment of $50x to FX1 that would be treated as interest for U.S. tax purposes but due to the Country X consolidation regime is disregarded for Country X tax purposes. The second is a payment of $100x of interest to an unrelated bank. Under Country X tax law, FX2's $200x of gross income is attributable to USB and is not included in FX2's income because Country X tax law exempts income attributable to a branch. Under U.S. tax law, the $200x of gross income is ECI. Under §882(c)(1), $75x of interest is allocable to such ECI. Of that $75x, $25x is treated as paid to FX1, being one-third of the total interest deemed paid by FX2 for U.S. tax purposes. That $25x is a disqualified hybrid amount under the disregarded payment rule and therefore a deduction for that amount is disallowed.

The second part of the example involves only a deemed payment, not an actual payment. All that happens is that under the income tax treaty between the United States and Country X, $25x of royalties is allowable as a deduction in computing the business profits of USB. The example states that under Country X tax law, the $25x is not taxed in Country X. Accordingly, the $25x is a specified payment that is a deemed branch payment. The entire $25x is a disqualified hybrid amount for which a deduction is disallowed because Country X does not tax FX2 on the $25 of deemed royalties.

Superficially, the deemed branch payment rule at first seems to make sense. After all, if the United States is not taxing all of the gross income of a U.S. branch of a foreign corporation, and the home country that would otherwise have claims to taxing the same income doesn't exercise its authority to do so, you have a classic case of "homeless income," which the anti-hybrid rules were intended to address.

Or do you? The United States exercises its taxing jurisdiction over foreign corporations having U.S. branches without regard to whether the same income is taxed to the foreign corporation at home. It is true that under tax treaties, the U.S.'s right to tax the income of a foreign corporation is limited to the case in which the foreign corporation has a "permanent establishment" in the United States. It is also true that in most such cases, the home country does not tax the same income over which the United States is exercising its tax jurisdiction. But none of this suggests that the United States has any claim to tax the gross income of a foreign person from U.S. activities. And in fact U.S. tax rules seek to tax only ECI, which is a net income concept.

It is one thing for the regulations to deny a deduction for interest or royalties actually paid by an entity treated as a U.S. taxable branch to a foreign person in a case where the payment is not taxed in the hands of the recipient by reason of the foreign country's laws. And it seems reasonable to avoid a double deduction by denying a deduction to the U.S. branch for amounts allocable to deductible payments made by the home office, a case arguably presented by the first part of the example above. But it is quite another thing to say that a deduction should be denied for a deemed payment arising under U.S. rules that seek only to measure the foreign corporation's net ECI, which is what is happening in the second part of the example. There is no reason why the home office should be taxing those deductions (and indeed hardly any conceivable rationale for doing so). The deemed branch payment rules go too far.

While the deemed branch payment rules go too far, the branch mismatch rules simply exceed the scope of the statute. The regulations address what are referred to as "branch mismatch payments" at Reg. §1.267A-2(e). Under the regulations, a specified payment is treated as a branch mismatch payment if (1) under the tax law of the home office, the payment is treated as attributable to a branch of the home office, and (2) under the tax law of the branch country, either the home office's activities do not give rise to a taxable presence, or the payment is treated as attributable to the home office and not to the branch. A branch mismatch payment is generally a disqualified hybrid amount to the extent that the home office does not include the payment in income.

The type of double non-taxation these rules are aimed at is well illustrated by the fairly recent state aid investigation involving a purported U.S. branch of a Luxembourg corporation (a Luxembourg subsidiary of McDonald's). [7] In that case, Luxembourg law treated the activities of the Luxembourg company in the United States as a branch or "permanent establishment." Because it did, and because the tax treaty between Luxembourg and the United States permits only the United States to tax the profits of a U.S. permanent establishment of a Luxembourg resident, Luxembourg did not tax what it saw as the income of the U.S. branch. Meanwhile, U.S. tax law did not consider the activities of the Luxembourg company to rise to the level of a permanent establishment, and for that reason did not impose tax on the nominal U.S. branch.

[7] For a complete description of the state aid case, see the website of the European Commission at: https://ec.europa.eu/commission/presscorner/detail/en/IP_18_5831.

One might have thought that in this situation, Luxembourg law would take notice of the fact that the United States did not consider the Luxembourg company to have a U.S. taxable branch, and for that reason might have asserted the authority to tax the income in Luxembourg. And in fact, following the state aid investigation, Luxembourg did just that.

While it is understandable that the IRS would seek to reverse the result in McDonald's, including by updating U.S. tax treaties, the anti-hybrid rules of §267A do not provide room to do so. Section 267A eliminates some obvious opportunities for taxpayers to create "homeless income" through the use of hybrid instruments and hybrid entities. The statute is specifically limited to hybrid entities and instruments. Congress should be presumed to know that the action item #2 of the BEPS project addressed not only hybrid mismatches, but also what were termed "branch mismatch arrangements." Yet §267A by its terms does not address branch mismatch arrangements. One must presume Congress had no intention that the regulations would do so. As the European Commission recognized, this problem needed to be fixed by Luxembourg, not by the United States.

Recognizing the express limitations of the statute, the preamble to the proposed regulations boldly stated:

> The proposed regulations **expand** the application of section 267A to certain transactions involving branches. This was necessary in order to ensure that taxpayers could not avoid section 267A by engaging in transactions that were **economically similar** to the hybrid arrangements that are covered by the statute. For example, assume that a related party payment is made to a foreign entity in Country X that is owned by a parent company in Country Y. Further assume that there is a mismatch between how Country X views the entity (fiscally transparent) versus how Country Y views it (not fiscally transparent). In general, section 267A's hybrid entity rules prevent a D/NI outcome in this case. However, assume instead that the parent company forms a branch in Country X instead of a foreign entity, and Country Y (the parent company's jurisdiction) exempts all branch income under its territorial system. On the other hand, due to a mismatch in laws governing whether a branch exists, Country X does not view the branch as existing and therefore does not tax payments made to the branch. Absent regulations, taxpayers could easily avoid section 267A through use of branch structures, which are **economically similar** to the foreign entity structure in the first example." [8]

[8] Preamble Special Analysis at Part I.D.3.iii. (emphasis added).

This is an astonishing statement. Essentially, the IRS is saying that "even though Congress did not see fit to address branch mismatch payments, we are going to do so on our own because we think branches could be used to get to the same economic results that Congress tried to prevent if done through hybrids." But what if Congress affirmatively decided NOT to cover branch mismatches? It might have made this decision for a number of reasons, not the least of which is administrative complexity.

It seems unlikely that taxpayers would affirmatively plan into branch mismatch structures to any significant degree. For such structures to "work," the country in which the branch is nominally located would have to have rules that did not tax the branch's income because the activities of the branch did not rise to the level of a taxable presence. That determination is notoriously difficult to ascertain with certainty. Not only must one determine that the host country will not tax the branch's activities, one must also determine that the branch owner's country will not impose a soak-up tax in the absence of host country taxation — which is why the McDonald's case involved a Luxembourg tax ruling. Moreover, most countries outside the United States take fairly consistent approaches to branch taxation, such that the opportunities for planning would often not be present.