Tax Structures using Branches and Hybrid Entities – Moving with the times
Use of hybrids and branches in tax structures

• Globalisation has caused business models to evolve
• Increasing use of hybrids and branches for their flexibility for cross border arrangements
• Raises concerns if these are used for unacceptable tax planning purposes
  – whether hybrid entities are used to obtain Singapore tax benefits and if so, the possible policy responses
  – whether branches can continue to be used for tax optimisation in light of recent tax developments
Tax arbitrage using hybrid entities – what should Singapore do?
Research scope and objective

• To find out whether hybrid entity mismatches are used to obtain Singapore tax benefits

• To discuss possible strategies for Singapore in response to the challenges posed by hybrid entity mismatches
What are hybrid entities?

- One that exhibits characteristics of both a company (i.e. fiscally opaque entity) and a partnership (i.e. a fiscally transparent entity)
  - e.g. US limited liability company

- Offers speed, flexibility and anonymity

- Hybridity arose from different entity classification and tax treatment under different tax codes
  - Therefore, tax arbitrage
How hybrid entities can be used to avoid tax

Three types of arbitrage opportunities:

1) Double deduction for the same payment in two different jurisdictions;

2) Deduction in one jurisdiction without a corresponding income to be charged to tax in another jurisdiction; and

3) Foreign tax credits that would otherwise not be available or be of a lesser amount.
What makes the tax planning work?

• Possibility to make an election relating to entity classification
  – US check-the-box rule

• Relatively liberal deduction of interest expense
  – Deduction of interest not matched strictly to the production of income

• Group consolidation/ group relief rules
  – Intra-group payments disregarded completely

• In this respect, arbitrage may not be easily replicated in jurisdictions that do not have similar features in their tax regimes
Hybrid entities are not used to achieve Singapore tax benefit

- Domestic tax regime offers limited incentive or opportunities for tax arbitrage:
  - Tax outcome from investing in a fiscally opaque or transparent foreign entity could be substantially similar
    - Foreign-sourced dividend exemption vs. double tax credit
  - Tax advantage not significant given Singapore’s competitive tax rate
  - Existence of anti-abuse provisions in income tax legislation restricts opportunities for arbitrage
    - Strict matching of income and expense
    - No group consolidation
    - More stringent conditions under the group relief regime compared to that of the UK
Hybrid entities are not used to achieve Singapore tax benefit

• According to tax practitioners, hybrid entity mismatch arrangements involving Singapore are rare:
  – Resultant tax benefit not significant
  – Uncertainty in respect of the characterisation of foreign entities makes planning less straight-forward
    • Tax outcome depends on entity classification
      – Yet to have any published position on the classification and treatment of hybrid entities for Singapore tax purposes
  • No mismatch if Singapore follows the classification of the foreign entity in its country of establishment
Is there a need for domestic anti-arbitrage rules?

• No necessity for domestic anti-arbitrage rules

• However, it would be useful to have an understanding of the tools available to tackle hybrid mismatches:
  – Reference drawn from UK tax regime
    • Entity classification rules
    • Anti-arbitrage rules
    • Disclosure of tax avoidance schemes ("DOTAS")
    • General anti-abuse rules ("GAAR") and other similar rules
  – OECD’s multilateral approach
UK GAAR enacted in 2013

- Traditionally relied on judicial means to counter tax avoidance
  - Purposive interpretation of legislation

- However, purposive interpretation to tax legislation is not a straight-forward exercise
  - May still result in outcome that could not have been intended by the Parliament

- A narrowly-focused anti-abuse rule targeting abusive tax avoidance schemes enacted in 2013

- Effectiveness of GAAR:
  - In the context of hybrid mismatches, GAAR may not be applicable if there are real underlying transactions and commercial considerations
  - UK introduced other forms of anti-abuse rules in 2015 e.g. diverted profits tax to address base erosion concerns
OECD BEPS Project

• Action Item 2 - neutralise the effects of hybrid mismatch arrangements:
  – Allowing a deduction in the payer jurisdiction to the extent that the payment is included as income in the payee jurisdiction

• Multilateral approach:
  – Requires cooperation among jurisdictions

• Effectiveness of a multilateral approach:
  – Unclear to extent to which jurisdictions will be amending their domestic rules to implement the recommendations
  – Success depends on all jurisdictions adopting the rules in a consistent manner
What could Singapore do?

• Little evidence that hybrid entities are being used to shift profits out of Singapore
  – Domestic anti-arbitrage rules do not seem necessary
  – Otherwise add to the complexity of the Singapore tax regime

• Enhancements could be made to improve the robustness of the domestic tax system
  – Which should not discourage genuine business activities
What could Singapore do?

• Introduce entity classification rules to provide certainty and clarity
  – Regard should be given to how foreign entities are being classified or treated for tax purposes in their countries of registration

• Strengthen the deterrent effect of domestic GAAR e.g. penalty regime

• Keep in view the need to introduce a disclosure regime
  – though motivation seems lacking at this point in time
Response to BEPS proposals

• Recommendations from BEPS action plan could be best practices
  – Singapore’s adoption should correspond to the risk Singapore faces

• Singapore’s implementation of the recommendations could be on the basis of a level playing field
Conclusion

• As long as there is difference in entity classification, there will be potential for mismatch

• There is still a place for hybrid entities
  – The challenge is to preserve genuine commercial activities while minimise room for tax abuse
Tax optimisation using branches?
Research scope and objective

• Narrowing gap in terms of tax treatment between branches and subsidiaries;

• In a MNE context, which legal entities within the structure can be replaced by branches?
  – Difference?
  – Advantages?
  – Disadvantages?
Narrowing gap between branches and subsidiaries

- Exemption of branch profits
- Branches = Subsidiaries?
- Convergence of principles in AoA with TPG post BEPS?
- Authorised OECD Approach (“AOA”)
# Framework

<table>
<thead>
<tr>
<th>Base Model</th>
<th>Variation 1 – Replace Op Cos with branches</th>
<th>Variation 2 - Replace Regional Hold Co with Branch</th>
</tr>
</thead>
</table>
| • Traditional Centralised Entrepreneur/Principal SCM  
  • ETR  
  • Impact of BEPS | • ETR  
  • Less PE risk  
  • Complications from foreign income receipt | • ETR  
  • Higher substance bar  
  • Complications from foreign income receipt  
  • Not sustainable in BEPS environment |
Diagram 1: Traditional Centralised Entrepreneur/Principal Supply Chain Model

- **Global Hold Co/Principal**
- **Regional Hold Co**
- **Kt Manuf**
- **LRD**
- **LRD**
- **LRD**

**Value chain analysis**
- Substance – Actions 8, 9 and 10
  - Value chain analysis

**Transparency and documentation**
- Action 5 – harmful tax practices
- Action 13 – TP documentation & CBCR

**Anti-abuse**
- Action 6 – anti treaty shopping
- Action 7 – Artificial avoidance of PE

**Other actions**
- Action 3 – CFC rules
- Action 4 – limit base erosion

- **WHT = 5%**
- **CIT = 25%**
- **WHT = 10%**

**ETR = 35.875%**
Diagram 2: Traditional Centralised Entrepreneur/Principal Supply Chain Model

Variation 1 – Replace Op Cos with branches

Advantages
- Less risk of being found with another PE

Disadvantages
- Receipt of foreign income
- Anti-abuse – action 6

ETR = 35.875%
Diagram 3: Traditional Centralised Entrepreneur/Principal Supply Chain Model:
– Variation 2 replace Regional Hold Co with Branch

Global Hold Co/Principal

Regional Hold Co

Kt Manuf
LRD
LRD
LRD

Cust
Cust
Cust

Advantages
- Higher substance bar
- Action 13 - Transparency and documentation

Disadvantages
- Action 6 - Anti-abuse
- Not sustainable

WHT = 5%

CIT = 25%
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ETR = 35.875%
Conclusion

• Branches can be used in the SCM
  – Exemption of branch profits
  – Facilitation by introduction of AoA
  – At the level of the OPCos in the SCM - BEPS anti-triangular provision
  – Minimisation of receipt of foreign income by OpCo branches
  – Proper transfer pricing and documentation
Conclusion

• Singapore can continue to play a role in the SCM
  – Modified territorial system
    • Good for traditional principal SCM
    • Good where SCM has OpCos which are branches
  – Double taxation relief issues for foreign income received by OpCo branches in Singapore
Conclusion

• The way forward
  – Optimistic – convergence with direction that BEPS is heading.
  – Less issue of substance with influence of AoA
  – Consolidation of substance using branches
  – Adoption of BEPS is a question mark – “wait and see”

• Interim
  – Certainty through APA?
Overall Conclusion

• Evolving and dynamic tax landscape going forward
• Open scorebook – whether hybrid entities and branches can still be used for tax optimisation purposes.
## Tax Differential (Diagram 1 vs 2)

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## Tax Differential (Diagram 1 vs 3)

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