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Tax
Issue P229/2015 – 7 October 2015

Tax Analysis

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Final BEPS reports released: An overall perspective

On 5 October 2015, ahead of the G20 Finance Ministers' meeting in Lima, Peru on 8 October, the OECD Secretariat published 13 final reports and an explanatory statement outlining consensus actions under the base erosion and profit shifting (BEPS) project. These reports include and consolidate the first seven reports presented to, and welcomed by, the G20 Leaders at the Brisbane Summit in 2014. (The OECD press release, explanatory statement and final reports can be accessed via the link: http://www.oecd.org/ctp/beps.htm)

Sixty-two countries have collaborated in the G20/OECD-led BEPS project, and they have agreed to continue working together until at least 2020. Many more countries participated in shaping the outcomes through regional structured dialogues; in particular, China has been an active participant throughout the process. Regional tax organizations, such as the African Tax Administration Forum, the *Centre de Rencontre des Administrations Fiscales* and the *Centro Interamericano de Administraciones Tributarias*, joined international organizations, including the International Monetary Fund, the World Bank and the UN, in contributing to the work.

There will be some more policy developments in 2016 and 2017, but the main activity will be in monitoring adoption of the BEPS measures. The monitoring group could be extended as other countries outside the project are invited to join. There is a precedent here, in the form of the *Global Forum on Transparency and Exchange of Information for Tax Purposes*, which now includes 127 countries and jurisdictions.

The G20/OECD working group notes that "although measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, today we know that the fiscal effects of BEPS are significant." The group estimates that BEPS has cost some 4%-10% of annual corporate tax revenues.

There are two significant questions on the BEPS actions: when will they be implemented, and which countries will implement the actions. The explanatory statement sets out the various levels of agreement:

> "All OECD and G20 countries commit to consistent implementation in the areas of preventing treaty shopping, country-by-country reporting, fighting harmful tax practices and improving dispute resolution. Existing standards have been updated and will be implemented, noting however that not all BEPS participants have endorsed the underlying standards on tax treaties or transfer pricing. In other areas, such as recommendations on hybrid mismatch arrangements and best practices on interest deductibility, countries have agreed a general tax policy direction. In these areas, they are expected to converge over time through the implementation of the agreed common approaches, thus

> enabling further consideration of whether such measures should become minimum standards in the future. Guidance based on best practices will also support countries intending to act in the areas of mandatory disclosure initiatives or controlled foreign company (CFC) legislation. There is agreement for countries to be subject to targeted monitoring, in particular for the implementation of the minimum standards. Moreover, it is expected that countries beyond the OECD and G20 will join them to protect their own tax bases and level the playing field."

The EU may decide to implement BEPS actions across the 28 member states. In June 2015, the European Commission published a communication on a *Fair and Efficient Corporate Tax System in the European Union*, which aims to set out how the BEPS measures can be implemented within the EU. The Council of Finance Ministers may choose to adopt BEPS measures across the EU.

Initial actions to take effect

The first actions to take effect will relate to the new transfer pricing approach (actions 8-10). Both the OECD and the UN model tax treaties require the use of arm's length pricing, and the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* provide the main guidance on application globally. The new consolidated version of the guidelines will not be published until 2017, but tax authorities already are starting to use material released in the public consultation in their approaches to open cases. For example, China recently issued a draft Revised Circular 2 for public comment. The new approach will require that multinationals start afresh with their functional analysis. The aim is to ensure that "transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them." This will mean that entities must be able to control the risks that give rise to potential rewards and, additionally, that mere legal ownership of an intangible asset is not sufficient to generate a significant return. "Capital-rich entities without any other relevant economic activities ("cash boxes") will not be entitled to any excess profits," which includes interest.

The next action to take effect will be country-by-country reporting to tax authorities, set out in action 13. There is a fixed template with very clear guidance on its use. All the main parent company countries have committed to this, so other countries will receive the benefit of additional information for risk assessment, provided they have a double tax treaty or a tax information exchange agreement with the parent company country or have signed the multilateral *Convention on Mutual Administrative Assistance in Tax Matters*. Some nongovernment organizations may complain that not all developing countries will get the information, but it should be noted that there are 127 countries in the *Global Forum on Transparency and Exchange of Information for Tax Purposes,* and 80 or so have signed the *Administrative Assistance Convention*. The first data (for December year-end groups with global sales of GBP 586 million; EUR 750 million; USD 840 million) must be delivered to tax authorities by 31 December 2017, which will, in turn, distribute the data by 30 June 2018. Multinationals are busy with their systems work on gathering the necessary data. China's approach in relation country-by-country reporting is reflected in the draft Revised Circular 2, which as noted above, was recently issued for public comment.

The final action to take early effect covers those countries with patent box or other intellectual property regimes. In the future, patent box incentives may be granted only where the related R&D is conducted in the same country. The UK is expected to present legislation quickly to introduce the new regime from June 2016 and to close the existing patent box regime; it is expected that group transfers into existing boxes will not be allowed after 31 December 2015. There are indications that Germany, Ireland and the US may introduce their own BEPS-compliant intellectual property regimes. Chins is currently also reviewing its own R&D incentive regime.

Actions likely to take effect from 2017 or later

Two important actions—hybrid mismatches and interest restrictions—will require national legislation. The OECD working party looking at these issues has provided over 400 pages of guidance to help countries legislate to counter hybrids (an instrument or entity which, through different treatment in two countries, achieves two deductions for the same economic expense or one deduction without equivalent income recognition). The approach to hybrids will mean that they will no longer be effective even if only one country enacts the anti-hybrid rules. The basic approach is to disallow the expense, with a secondary rule to tax the income where the payer country does not counter the deduction. One of the challenges is obtaining sufficient information to establish that there is a hybrid effect. The UK has indicated it will consider legislation from 1 January 2017; few other countries have yet offered public support, although some (e.g. France) consider that hybrids already are ineffective under their current law.

The recommendations for interest restrictions provide that countries should limit interest deductions to a fixed percentage of earnings before interest, tax and depreciation (EBITDA). The cap should be in the range of 10%-30%. Countries may optionally offer a "fall-back" of a group-wide ratio of third-party net interest expense, should this be higher. There are other options put forward, including a *de minimis* limit to exclude low levels of debt and the ability to carry forward and back excess interest. Additionally, third-party debt to finance public-benefit projects may be excluded, subject to certain conditions. Australia already has indicated that it will not implement this action, and it seems that Germany and certain other European countries consider that their existing rules broadly satisfy the action. The US Congress and the Treasury Department both would like to limit interest deductions, but Congress is not expected to legislate, except as part of wider corporate tax reform. It is thought likely that the UK will issue a consultation later this autumn on how this action might be implemented in the UK.

Actions requiring amendments to double tax treaties

The multilateral instrument is intended to allow the effective modification of many treaties, and will be negotiated during 2016. The initial conference to negotiate the convention starts on 5 November 2015, under the chairmanship of the UK, supported by vice-chairs from China and the Philippines. Over 90 countries and jurisdictions have indicated they will participate in the negotiation. The multilateral instrument must be completed by the end of 2016 and then will be available for countries to ratify. It is expected that there will be significant flexibility within the instrument, such that participating countries may make different choices.

The areas to be covered by tax treaty changes are permanent establishments (PEs) (taxable presence); treaty abuse; and dispute resolution. There also is a small change to cover aspects of hybrid mismatches.

The wide-ranging PE changes are intended to lower the threshold for recognizing a taxable presence. The first area is reducing the importance of the place where a contract is legally entered into. Action 7 notes: "As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business. The changes to Art 5(5) and 5(6) and the detailed Commentary thereon address commissionaire arrangements and similar strategies by ensuring that the wording of these provisions better reflect this underlying policy." These changes, once implemented, is expected to materially impact business models which involve the use of related Chinese marketing services companies in relation to goods and services sold from offshore to Chinese buyers and consumers.

The second area for change limits the use of exemptions "to ensure that profits derived from core activities performed in a country can be taxed in that country." The exemptions in article 5(4) of the OECD model treaty will be modified to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary'' character. There also is an anti-fragmentation rule to limit multinationals from splitting activities to avoid a taxable presence.

Additionally, to provide greater certainty about the determination of profits to be attributed to the PEs that will result from the changes and to take account of the need for additional guidance on the issue of attribution of profits to PEs, follow-up work on attribution of profits issues will be carried out with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument. Taxpayers who potentially have Chinese PEs should also monitor developments in China in relation to the use of "deemed profit" v "attribution of actual profits" amongst Chinese tax authorities.

The treaty abuse action springs from concern that double tax treaties could be used to make available treaty benefits in circumstances not intended by the treaty signatories. Countries have agreed to include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping (routing payments via a treaty country to reduce taxes). They also agree that some flexibility in the implementation of the minimum standard is required, since these provisions need to be adapted to each country's specificities and to the circumstances of the negotiation of bilateral conventions. The approaches put forward are limitation on benefits rules (currently used by Japan and the US) and principal purpose tests (currently used by many other countries, including the UK). There are indications that China is considering the use of both limitation of benefits and the principal purpose tests. Collective investment vehicles (widely-held funds) will be able to qualify for treaty benefits in some circumstances. There also will be optional specific measures.

The dispute resolution action is most important. The explanatory statement notes: "Double taxation would harm multinationals which have contributed to boosting trade and investment around the world, supporting growth, creating jobs, fostering innovation and providing pathways out of poverty. Double taxation would also increase the cost of capital and could deter investment in the economies concerned."

The measures developed under action 14 aim to strengthen the effectiveness and efficiency of the mutual agreement procedure (MAP) where cases are settled between countries. The OECD's statistics on the MAP show that there were over 4,600 cases at the end of 2013 between OECD members and four partner countries, including 1,900 new cases in the year.

The new minimum standard will ensure that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner, and also will ensure that taxpayers can access the MAP when eligible.

Additionally, there will be a "robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20." This type of mechanism has worked well in the *Global Forum on Transparency and Exchange of Information for Tax Purposes*, and it is intended that this will help ensure consistent application of the MAP in the future.

Twenty countries, covering 90% of reported open MAP cases, but which do not include China, have said that they will add mandatory binding arbitration to their tax treaties, using the "last best offer" approach. This requires the independent arbitrator to choose between one of the proposals put forward by the countries, rather than making his or her own decision. The mechanism for adding arbitration presumably would be the multilateral instrument, although the US (one of the 20) has not yet decided to participate in the negotiations.

Further work

The G20/OECD will undertake more work in 2016 on several actions:

- Harmful tax practices: Revision of criteria, expanding participation of non-OECD countries;
- Treaty abuse: Treaty entitlement of certain funds;
- Interest: Finalization of the design of the group ratio carve-out, special rules for banking and insurance;
- PEs: Profit attribution rules; and
- Transfer pricing: Financial transactions, use of the profit split method.

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